Parliamentary Joint Committee on Corporations and Financial Services

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Corporate Insolvency Laws: a Stocktake

June 2004

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DUTIES OF THE COMMITTEE

Section 243 of the *Australian Securities and Investments Commission Act 2001* sets out the duties of the Committee as follows:

The Parliamentary Committee's duties are:

(a) to inquire into, and report to both Houses on:

(i) activities of ASIC or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of the corporations legislation (other than the excluded provisions), or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

TERMS OF REFERENCE

On 14 November 2002, the Parliamentary Joint Committee on Corporations and Financial Services agreed to consider and report on the operation of Australia's insolvency and voluntary administration laws, including:

(a) the appointment, removal and functions of administrators and liquidators;

(b) the duties of directors;

(c) the rights of creditors;

(d) the cost of external administrations;

(e) the treatment of employee entitlements;

(f) the reporting and consequences of suspected breaches of the *Corporations Act 2001*;

(g) compliance with, and effectiveness of, deeds of company arrangement; and

(h) whether special provision should be made regarding the use of phoenix companies.

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ACRONYMS AND ABBREVIATIONS

ABA	Australian Bankers' Association
ACTU	Australian Council of Trade Unions
ADI	Authorised Deposit-taking Institution
AFR	*Australian Financial Review*
AICD	Australian Institute of Company Directors
ALRC	Australian Law Reform Commission
AMWU	Australian Manufacturing Workers' Union
ASC	Australian Securities Commission
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
AWU	Australian Workers' Union
CALDB	Companies Auditors and Liquidators Disciplinary Board
CAMAC	Corporations and Markets Advisory Committee
CASAC	Companies and Securities Advisory Committee
CLA	Commercial Law Association
CLERP	Corporate Law Economic Reform Program
COSBA	Council of Small Business Organisations of Australia
CPA	Chartered Professional Accountants
CVA	Corporate Voluntary Arrangement (UK)
CVL	Creditors' Voluntary Liquidation
DCA	Deed of Company Arrangement – also referred to as DCOA
DOCA	see DCA entry
EXAD	External Administration Project
GEERS	General Employee Entitlements and Redundancy Scheme

Harmer Report	Australian Law Reform Commission, Report No 45.
HIH	Insurance company whose recent collapse resulted in many organisations and individuals being left without insurance cover
ICAA	Institute of Chartered Accountants in Australia
IPAA	Insolvency Practitioners Association of Australia
MPP	Maximum Priority Proposal
NNF	National Farmers' Federation
NIT Program	The National Insolvent Trading Program
RATA	Report as to Affairs
SGC	Superannuation Guarantee Charge
QBE	Queensland Bankers Equitable (a company providing various business and general insurance products)
UNICITRAL	United Nations Commission on International Trade Law
UK	United Kingdom
US	United States (of America)
VA	voluntary administration

EXECUTIVE SUMMARY

Corporate insolvency

The provisions of the Corporations Act that deal with corporate insolvency are primarily concerned with efficient procedures for the winding up of companies, the orderly realisation of the available assets of those companies and the equitable distribution of the proceeds to creditors (including employees) and shareholders. They include procedures governing corporate rescue or reorganisation (as an alternative to liquidation) set out in Part 5.3A of the Corporations Act. There are also provisions governing the appointment of receivers or other persons who are entitled to assume control over particular assets of the company, the reconstruction of companies, arrangements and compromises with creditors and the voluntary winding up of companies.

The Committee appreciates that a wide range of policies and objectives must be taken into consideration in the design of an insolvency law. An effective insolvency regime must achieve a careful balance of multiple and even conflicting policies and objectives. The foremost objective, in the Committee's view, is to promote and maximise trust and confidence in the operation of insolvency law on the part of the community in general and the business and corporate sector in particular. In its approach to the range of issues it had to consider, the Committee placed importance on the following objectives and values:

- encouraging early intervention in the affairs of companies in financial difficulties and restoring companies to profitable trading where practicable;
- striking a balance between voluntary administration and liquidation;
- protecting the interests of creditors and, in particular, employees in circumstances of financial difficulty and corporate malpractice;
- maximising the value of an insolvent company's assets;
- reducing the cost of credit; and
- encouraging the good management of companies and deterring malpractice and, in particular, abuses of the corporate form and insolvency procedures generally.

Role of the administrator

Every major review of the policies that underpin insolvency law has emphasised the role that insolvency administrators play and the need to ensure they are competent to exercise the powers given to them and that they act with integrity, impartiality and independence.

Problems about the lack of independence of external administrators were commonly expressed in submissions and confidential evidence received by the Committee into the conduct of particular administrations.

23.1 The Committee considers that a statement of independence which would disclose professional, personal or business relationships between the administrator or his/her firm and the company or its officers, members or creditors would be an important factor not only to improve the perception of independence but encourage actual independence. It would alert creditors to any possible conflict of interests that the administrator may have and assist them at their first meeting in considering whether or not to remove the administrator.

In the Committee's view, it is reasonable to allow creditors who have reservations about the objectivity of an administrator to be able to choose another person to be liquidator. Allowing creditors to have an effective say in the appointment and removal of administrators also counters perceptions of a lack of independence and accountability on the part of administrators. The Committee recommended that creditors should be able to appoint a different person as liquidator when the administration ends and the company proceeds into liquidation, and when a deed of company arrangement ends and the company proceeds into liquidation.

The Committee believes that it is inappropriate for a casting vote to be used in relation to any resolution concerning the administrator’s replacement and recommended that the use of the casting vote in such circumstances be prohibited. Using identical reasons, the Committee considers it inappropriate for an administrator to have a casting vote in relation to any resolution concerning his/her remuneration.

While the independence of administrators is essential in maintaining the integrity of the insolvency system, that Committee accepts that the qualifications and professional standards of practitioners is of primary importance also.

It endorses the emphasis that ASIC places on practical experience in external administration, especially managerial skills, as a prerequisite for registration and recommends that this focus should remain strong. It does, however, recommend that the criteria for registration as an insolvency practitioner be broadened to recognise qualifications in other relevant disciplines including legal practice.

Duties of directors

The Committee discussed the duties of directors when their company gets into financial difficulties. It made recommendations that would further assist liquidators in their duties to recovery debts for the benefit of creditors. They are intended:

- to promote a greater awareness among directors of their obligations to ensure that the company maintains proper financial records;
- to make directors more accountable for failing to keep proper records; and

- to increase the scope for the recovery of debts created through uncommercial transactions.

In particular, the Committee emphasises that good record keeping is an essential feature of good corporate governance. Although the law already allows for directors to be held accountable for incomplete record keeping, the Committee believes that this clearly is an area that calls for greater vigilance.

The Voluntary Administration

While many submissions were critical of particular features of the VA procedure and suggested alternative approaches in a number of areas, overall submissions commented positively on the procedure. The general view expressed in submissions was that the VA process is a useful and valuable procedure for companies that may be facing collapse.

The Committee is of the view that the VA procedure has been a successful innovation and should be retained as a central feature of Australian insolvency law. After a decade of operation it appears to be functioning effectively and providing adequate opportunities for businesses in financial difficulty to reorganise. It generally strikes a reasonable balance between liquidation and reorganisation. In the event that reorganisation or rescue is impossible, the VA procedure permits a prompt transition to a predictable, fair and orderly liquidation procedure in which losses are distributed appropriately and minimised to the extent possible. The flexibility that is inherent in the procedure in most cases achieves a balance between the interests of debtors and creditors. It has become an increasingly popular form of external administration. Voluntary administrations now form a significant, if not a major, part of the practice of most insolvency practitioners.

Chapter 11

Most submissions that commented on the US Chapter 11 model argued strongly against its adoption. Two of the major concerns expressed about a Chapter 11 regime were—the company remaining in the hands of the debtor and the length of the process.

The Committee is not persuaded to the view that an insolvency procedure modelled on Chapter 11 of the US Bankruptcy Code is appropriate for the Australian corporate sector. Nor does it consider that wholesale amendments to the voluntary administration procedure to conform to Chapter 11 would have the potential to make a significant improvement in outcomes that are presently achievable under the VA procedure.

Protecting creditors' rights

The Committee examined the scope for effective participation by differently placed creditors in the voluntary administration and other insolvency procedures. It recommends that the time frame for the first and second creditors' meeting be

extended to allow the administrator to better prepare material for the meetings and to allow creditors time to digest this material in readiness for the meetings at which major decisions are taken. It also recommends that the administrator's report include any matter that is material to a creditor's decision; that better and more effective use be made of technology in communicating with creditors, that sensible measures be taken to keep costs to a minimum by using alternative methods for conducting minor procedural meetings; and that ASIC assume a more active role in the education of creditors as to their rights and obligations.

Administrators' fees

The Committee received numerous comments on the fees charged by insolvency practitioners. They clearly indicated a widespread perception that fees for insolvency services are high and may be unnecessarily so. The Corporations Act does not prescribe remuneration levels. Rather it encourages administrators and creditors to reach agreement on the question of remuneration as between themselves.

The Committee considers that in light of concerns about the impact on competition, a scale of maximum fees is inappropriate. It was not convinced that fees should be regulated but accepts that enhanced disclosure of the basis of fee setting could address some of the concerns expressed by creditors. The Committee believes that the market should be allowed to determine the most efficient and cost-effective fee setting mechanisms. Nonetheless, it was of the view that unsophisticated creditors should have the capacity to negotiate meaningfully with practitioners about fees levied for external administrations. The Committee identified a need for creditors to be aware of the circumstances surrounding the fees and charges of insolvency practitioners. Accordingly, the Committee recommended that ASIC work with the professional bodies to encourage the promotion of best practice standards in remuneration charging and in particular the provision of adequate disclosure of the basis of fees charged by insolvency practitioners and on a more timely basis.

Assetless companies

The Committee considers that the question of assetless administrations is one of the more difficult, longstanding and important issues that it has had to consider.

There are sound reasons for ensuring that assetless companies undergo some form of administration. Otherwise there is no mechanism for detecting and possibly curbing the reoccurrence of breaches of the law. For example, in anticipation of the formal commencement of insolvency proceedings, it is possible that unscrupulous directors may attempt to hide assets from their creditors, favour certain creditors over others, incur artificial liabilities, make gifts to relatives or friends or transfer the business and assets to another company set up for that purpose. Such transactions would be unfair to the company's unsecured creditors. If the company leaves insufficient assets to pay for an administration and no liquidator is able to carry out an administration, there is the strong likelihood that these transactions will not be investigated or payments not

recovered for the benefit of creditors. These circumstances potentially leave an avenue for abuse.

The Committee believes that the problem of assetless administrations is an example of a market failure, giving rise to problems that call for an appropriate regulatory solution in the public interest. An alternative option for addressing this market failure is the creation of a public office in ASIC similar to that of the Insolvency Service in the UK. This Service undertakes, in every winding up order, the initial investigation into a company's failure, the causes of failure and generally the promotion, formation, business dealings and affairs of the company and makes its report to the court. If assets are available to fund the administration a private practitioner is appointed.

The Committee considers that the establishment of an assetless administration fund along the lines recommended by the Harmer Report and supervised by ASIC is a more cost effective and efficient mechanism than the establishment of a new government agency or division within ASIC along the lines of the UK Insolvency Service.

Phoenix company activity

Phoenix company schemes have been a longstanding concern of regulatory agencies, parliamentary committees and other bodies of inquiry. The main legislative approach dealing with phoenix company activity has not been to define phoenix activity as such but rather to provide for disqualification of directors in certain circumstances and set penalties for contravening the disqualification.

The Committee examined the impact of fraudulent phoenix company activities and measures for their prevention. It looked at the current provisions for the disqualification of directors and suggests that the legislation take a firmer position on banning directors for dishonest conduct intended to deceive or defraud creditors. It has also recommended that measures be put in place to improve the collection and availability of databases so that the detection of fraudulent phoenix activity is more effective.

The Committee considers that ASIC or a court should have the capacity to consider whether the facts and circumstances of a person's conduct and involvement in relation to a particular company or in relation to two or more companies are serious enough overall to warrant a finding that a person should be disqualified from managing a company for a period of time.

The Committee believes that these amendments will broaden the circumstances in which ASIC may disqualify a person and allow persons who should not remain as directors to be removed or disqualified quickly. Of course, any amendment should allow persons appropriate appeal rights.

In particular, the Committee recommends that ss 206D and 206F should not be subject to a requirement to have managed two or more failed corporations. They should permit a Court, or ASIC in its discretion, to disqualify a person from being a director where essentially two conditions are met: the person is or has been a director of a

company which has failed (as defined in s 206D(2)) and the person, as a director of the company (either taken alone or taken together with his/her conduct as a director of any other company) makes him or her unfit to be concerned in the management of a company.

The Committee considers that the evidence presented to it points to a clear connection between the problem of assetless companies and phoenix company schemes. The evidence underlines the importance of the Committee's recommendation concerning the need to establish an assetless administration fund to finance preliminary investigations by registered insolvency practitioners of breaches of directors' duties and fraudulent conduct. The assetless companies and phoenix company syndrome will only be addressed properly when a funding mechanism for the investigation and prosecution of offenders is instituted.

Employee entitlements

The Committee examined features of the law that aim to protect employee entitlements, the ranking of debts, and in particular employee entitlements, in the order for payment under insolvency law and the proposal to pay out certain employee entitlements ahead of other creditors, including secured creditors, upon liquidation.

The Committee considers that the protection of employee entitlements in the circumstances of employer insolvency is an important public policy and it is appropriate for governments to explore options for better protecting such entitlements. The Government's foreshadowed proposal to pay out certain employee entitlements ahead of all other creditors, including secured creditors, does not appear to the Committee to be the most effective means to achieve this objective. The Committee is not persuaded that the ranking of debts for payment under the current law should be altered.

The factors that the Committee took into account in reaching this conclusion include:

- the uncertain impact on secured lending practices;
- the potential increased cost of secured lending and the passing on of these costs to borrowers;
- greater complexity in the conduct of external administrations;
- avoidance behaviour by secured creditors to protect their positions;
- the impact on businesses that have large numbers of employees or long serving employees relative to those that do not;
- tensions arising from the differential treatment of large and small businesses and confusion arising from a change in status when a small company becomes a large one and vice versa; and

- the long hiatus period in which the legal effect of the maximum priority proposal will be uncertain.

An important element of Commonwealth arrangements for the protection of employee entitlements in the event of employer insolvency is the General Employee Entitlements and Redundancy Scheme (GEERS) which protects the entitlements of employees whose employment has been terminated due to their employer’s insolvency.

In the Committee’s view, GEERS is an important aspect of the overall arrangements for the protection of employee entitlements in Australia and should continue to be a feature of those arrangements. As to extending its coverage, the Committee believes that it should cover superannuation entitlements, particularly in light of steps that have been taken to ensure that employees' superannuation contributions are being made.

Even so, the Committee is concerned about the likelihood of any loss of superannuation benefits. It accepts the argument about the importance of superannuation and during its deliberations on this matter focused on measures to ensure that contributions are made and protected rather than to trying to recover lost contributions after a company fails. The recently introduced quarterly payment of the superannuation guarantee charge is one such measure designed to keep any losses to a minimum.

The Committee understands that it is too early to make an accurate assessment of the impact of the quarterly arrangements for the collection of the superannuation guarantee charge and whether strengthened enforcement measures are required. Nonetheless, it welcomes this change as a constructive measure to help minimise the potential loss of superannuation entitlements that employees may face when a company fails. It would like to see the arrangements for the quarterly collection of the superannuation guarantee charge closely monitored and for Treasury to periodically publish its assessments of the operation of the scheme and its effectiveness in safeguarding employees' superannuation benefits.

Deed of company arrangement

The Committee considered the impact of deeds of company arrangement and measures to enhance the rights of creditors in relation to such deeds. It accepts that the law provides for the rights of creditors in the process of formulating a deed of company arrangement (DCA) and during the period in which the company is subject to a DCA. However, it is necessary to recognise the imbalance in power and sophistication among creditors. Due to a superior level of knowledge and experience of insolvency procedures some creditors are better placed to exercise their rights than others. The Committee believes that the availability of appropriately targeted information can assist in addressing the imbalance between creditors and allow inexperienced creditors to participate actively in insolvency procedures and achieve better overall outcomes for themselves.

Cross-border insolvency

The adoption of the United Nations Commission on International Trade Law (UNCITRAL) Model Law and Australia's active role in promoting cross-border cooperation in insolvency proceedings will go some way to assist in the recovery of assets located in foreign countries. It does not, however, tackle the problem of companies that deliberately set out to conceal assets and place them beyond the reach of legitimate claimants by using overseas companies or foreign transactions to deny access to creditors. Such a recovery process is time consuming and costly. The Committee believes that more should be done to assist creditors in the retrieval of assets held off shore by companies that have collapsed.

The following section lists the recommendations contained in the report.

RECOMMENDATIONS

RECOMMENDATION 1

3.58 The Committee recommends that the law should require administrators to make available a statement of independence before the first meeting of creditors disclosing any professional, personal or business relationship between the administrator or his/her firm and the company or its officers, members or creditors. There should be provision for appropriate sanctions for false or misleading statements.

3.59 Further, the Committee recommends that the administrator be under an obligation to disclose conflicts of interest if and when they arise.

RECOMMENDATION 2

3.69 The Committee recommends that creditors should be able to appoint a different person as liquidator when the administration ends and the company proceeds into liquidation, and when a deed of company arrangement ends and the company proceeds into liquidation.

RECOMMENDATION 3

3.73 The Committee recommends that an administrator should be prohibited from using a casting vote in a resolution concerning his or her replacement.

RECOMMENDATION 4

3.77 The Committee recommends that the prohibition in s 595—inducements to be appointed liquidator etc. of a company—be extended to include not only members and creditors, but also directors and any other person or entity.

RECOMMENDATION 5

3.96 The Committee strongly endorses the heavy emphasis that ASIC places on practical experience in external administration, especially managerial skills, as a prerequisite for registration as a liquidator and recommends that it should not be weakened. It does, however, recommend that the criteria for registration as an insolvency practitioner be broadened to recognise qualifications in other relevant disciplines including legal practice.

RECOMMENDATION 6

3.104 The Committee recommends that the law should provide for procedures to be in place to monitor insolvency practitioners to ensure that they continue to meet on-going registration criteria in regard to education including continuous education

requirements, skills, resources, membership of an appropriate professional body, experience and fitness for registration.

RECOMMENDATION 7

3.111 The Committee recommends that the Government consider establishing an advisory council comprising representatives of professional organisations including the Insolvency Practitioners Association of Australia, CPA Australia, the Institute of Chartered Accountants in Australia, and the Law Council to assist ASIC in relation to the regulation, appointment, registration and removal of registered and official liquidators as well as on issues relating to the maintenance of professional standards of insolvency practitioners.

RECOMMENDATION 8

4.15 The Committee recommends that, in its enforcement programs for the lodgement of reports as to the affairs of a company (RATAs), ASIC take greater account of the quality of reports provided.

RECOMMENDATION 9

4.20 The Committee is concerned about the allegations of poor record keeping and believes that the current penalty regime for breaches of section 286 may not be adequate. The Committee recommends that the Government review the penalties attached to breaches of section 286 with a view to making them more effective as a deterrent.

RECOMMENDATION 10

4.23 The Committee recommends that the Government consider amending the law to permit an administrator or a liquidator to recover from directors who have failed to ensure that company records are complete and up-to-date, the costs and expense of reconstructing the company's financial records in order to prepare a full and complete report on the affairs of the company. Directors would be held jointly and severally liable.

RECOMMENDATION 11

4.45 The Committee recommends that ASIC issue a practice note as to what constitutes insolvency for the guidance of company directors passing solvency resolutions and making director's declarations.

RECOMMENDATION 12

4.49 The Committee recommends that reg. 5.3A.02—administrator to specify voidable transactions in statement—be amended to include rights of recovery against the company's directors for insolvent trading.

RECOMMENDATION 13

4.60 The Committee recommends that insolvency be removed as a prerequisite for the avoidance of uncommercial transactions which may be challenged by a liquidator. Such transactions are to have taken place during the two year period preceding formal insolvency.

RECOMMENDATION 14

5.52 The Committee recommends that the threshold test permitting directors to make the initial appointment of an administrator under the voluntary administration procedure be revised in order to alleviate perceptions that the VA procedure is only available to insolvent companies. The Committee notes the suggestion that the test be reworded to read 'the company is insolvent or may become insolvent'.

RECOMMENDATION 15

6.24 The Committee believes that the first meeting of creditors should be retained but the time frame for the meeting be extended. It does not favour a lengthy extended period. The Committee recommends that the first meeting be held within eight business days after the beginning of the administration with a requirement for five business days' notice of the meeting to creditors.

RECOMMENDATION 16

6.37 The Committee recommends that the period for holding the second meeting of creditors be extended to 25 business days with a new convening period of 20 business days. The adjournment period is to remain at 60 days.

RECOMMENDATION 17

6.43 The Committee recommends that the administrator's report to creditors at the second meeting of creditors be required to include 'any other matter material to the creditors' decision'.

RECOMMENDATION 18

6.44 The Committee further recommends that ASIC publish a guidance note to assist administrators in ensuring that administrators include all matters material to the creditors' decision in their administrator's report.

RECOMMENDATION 19

6.86 The Committee recommends that the Government consider alternatives to the current advertising and gazettal requirements for external administrations.

RECOMMENDATION 20

6.93 The Committee recommends that the Government consider making technology and e-commerce options more widely available to enhance communication with stakeholders in external administrations and reduce the costs of external administrations.

RECOMMENDATION 21

6.98 The Committee recommends that the provisions of Chapter 5 be amended with a view to permitting alternative methods of conducting minor procedural meetings.

RECOMMENDATION 22

6.107 The Committee recommends that ASIC provide, from the perspective of an unsophisticated, unsecured creditor who may be affected once only by an insolvency proceeding, a series of Frequently Asked Questions or other suitable materials that address the issues they may need to consider as creditors of a failed company, and which explains the law and outlines options and issues that they may need to address.

RECOMMENDATION 23

7.17 The Committee recommends that a court should have the power to review the remuneration of administrators and deed administrators on the application of ASIC.

RECOMMENDATION 24

7.23 The Committee recommends that ASIC work with the professional bodies to encourage the promotion of best practice standards in remuneration charging and in particular the provision of adequate disclosure of the basis of fees charged by insolvency practitioners and on a more timely basis.

RECOMMENDATION 25

7.25 The Committee recommends that an administrator should be prohibited from using a casting vote in a resolution concerning his or her remuneration (see also recommendation 3).

RECOMMENDATION 26

7.27 The Committee recommends that ASIC, in consultation with the relevant professional bodies, implement appropriate means to educate unsecured creditors about the different methods of fee setting available and the rights which creditors have with regard to the setting of fees (see also recommendations 22 and 50).

RECOMMENDATION 27

7.28 The Committee recommends that ASIC periodically sample the fees charged by insolvency practitioners and make public a comparative report.

RECOMMENDATION 28

7.50 The Committee is of the firm belief that the problem of assetless companies must be addressed. It recommends that the Government establish an assetless company administration fund to finance preliminary investigations of breaches of directors' duties and fraudulent conduct using the skills of registered insolvency practitioners.

RECOMMENDATION 29

7.56 The Committee recommends that, as a step towards a better understanding of the nature, effects and extent of insolvent assetless companies, the Government should commission an empirical study of assetless companies.

RECOMMENDATION 30

7.57 The Committee further recommends that as a first and immediate step, ASIC begin to collate statistics on insolvent assetless companies and publish such figures on a triennial basis together with an analysis.

RECOMMENDATION 31

8.59 The Committee recommends that ss 206D and 206F should not be subject to a requirement to have managed two or more failed corporations. They should permit a court, or ASIC in its discretion, to disqualify a person from being a director where essentially two conditions are met: the person is or has been a director of a company which has failed (as defined in s 206D(2)) and the person, as a director of the company (either taken alone or taken together with his/her conduct as a director of any

other company) makes him or her unfit to be concerned in the management of a company.

RECOMMENDATION 32

8.69 The Committee recommends that the Government in association with the Council of Australian Governments review the adequacy of the arrangements for the checking of the business names of companies on State Business Names Registries against the ASCOT database of company names and ACNs.

RECOMMENDATION 33

8.81 The Committee recommends that the Government consider the proposal to create a statutory process analogous to a Mareva injunction to enable the courts to freeze assets of a director or manager which are prima facie assets on which the corporation has a just claim.

RECOMMENDATION 34

8.84 The Committee recommends that the Government review the processes in place for registering a company with a view to improving the measures for determining the bona fides of those applying to register a company.

RECOMMENDATION 35

8.86 The Committee recommends that ASIC consider establishing a hot-line and guidelines for its operation in conjunction with strategically located employees for the purpose of facilitating possible early detection of, and intervention to prevent the implementation of, illicit phoenix activities.

RECOMMENDATION 36

8.94 The Committee recommends that the insolvency related implications and recommendations of the Companies and Securities Advisory Committee's *Report on Corporate Groups* should be examined by the Government and its response made available to the Committee as soon as possible.

RECOMMENDATION 37

9.12 The Committee recommends that in its enforcement programs for the lodgement of external administrators' statutory reports, ASIC also take greater account of the quality of reports provided.

RECOMMENDATION 38

9.41 The Committee recommends that the level of funding for ASIC take account of the demands and complexities of corporate insolvency laws and the need to investigate properly and enforce contraventions of the law exposed by corporate collapses.

RECOMMENDATION 39

9.42 The Committee requests that ANAO conduct a performance audit of ASIC's processes in receiving and investigating statutory reports.

RECOMMENDATION 40

9.44 The Committee recommends that ASIC consider enhancing its capacity to provide more comprehensive, comparable analyses of statutory reports of liquidators for the assistance of journalists, academic researchers, the public and the Government and its own management requirements. Such information should be assessed in terms of maintaining public confidence in the administration and enforcement of corporate laws.

RECOMMENDATION 41

9.47 The Committee recommends that ASIC continuously evaluate the incidence of possible failures to keep books and records adequately as disclosed in external administrators' reports on an annual comparative basis. This measure would allow ASIC to assess the effectiveness of its annual programs for the enforcement of financial reporting requirements.

RECOMMENDATION 42

10.55 The Committee recommends that the maximum priority proposal not be adopted. The emphasis in any reform proposals in relation to employee entitlements should be on preventative measures to minimise the risk of loss of employee entitlements and modifying current behaviour to ensure directors and managers of companies take greater responsibility in meeting the cost of employee entitlements in the event of business failure.

RECOMMENDATION 43

10.67 The Committee recommends that the Minister for Finance request the Corporations and Markets Advisory Committee to review the operation of the *Corporations Law Amendment (Employee Entitlements) Act 2000* to determine its effectiveness in deterring companies from avoiding their obligations to employees. Furthermore, in light of the evidence suggesting that some corporations deliberately

structure their business to avoid paying their full entitlements to employees and more generally unsecured creditors, the Committee recommends that the review look beyond the effectiveness of the Act and consider, and offer advice on, possible reforms that would deter this type of behaviour.

RECOMMENDATION 44

10.87 The Committee recommends that the Government explore the various measures proposed for safeguarding employee entitlements such as insurance schemes or trust funds giving particular attention to the costs and benefits involved in the schemes.

RECOMMENDATION 45

10.113 The Committee recommends that the Government monitor the impact of the quarterly arrangements for the collection of the superannuation guarantee charge to determine whether there is a need for strengthened enforcement measures.

RECOMMENDATION 46

10.117 The Committee recommends that the Government clarify inconsistencies between the Superannuation Guarantee (Administration) Act and the Corporations Act and clarify how the Superannuation Guarantee Scheme is intended to operate in relation to employers that are under one or other form of external administration.

RECOMMENDATION 47

10.120 The Committee recommends that the Government clarify the priority afforded superannuation contributions required to be made after the ‘relevant date’ of an external administration.

RECOMMENDATION 48

10.124 The Committee recommends that the Government consider the inclusion of superannuation contributions in GEERS.

RECOMMENDATION 49

11.20 The Committee recommends that the law be amended to make it mandatory for a deed of company arrangement to preserve the priority available to creditors in a winding up under s 556(1), unless affected creditors agree to waive their priority. The amendment should, however, allow creditors or the administrator the right to initiate court proceedings to have the deed upheld if in the Court's view the deed offered the dissenting creditors a better return than they would obtain in a liquidation.

RECOMMENDATION 50

11.29 The Committee recommends that ASIC work with the IPAA to educate unsophisticated creditors about their rights in the process of formulating a deed of company arrangement and during the period in which the company is subject to a DCA.

RECOMMENDATION 51

11.31 The Committee recommends that the IPAA take note of the criticism raised about insolvency practitioners and the information they make available to creditors about DCAs. It would like to see the IPAA adopt a strong and active position to ensure that its members take seriously their responsibilities and obligations to inform creditors about all aspects of the DCA.

RECOMMENDATION 52

11.33 The Committee recommends that the law be amended to clarify that a DCA which incorporates any form of promise of future performance should not be regarded as finalised until all such promises have been fulfilled.

RECOMMENDATION 53

11.38 The Committee recommends that ASIC work with the IPAA to inform unsophisticated creditors about the options open to them for the purpose of monitoring the fulfilment of terms of DCAs and reporting on compliance.

RECOMMENDATION 54

12.23 The Committee recommends that the creditors' voluntary liquidation procedure should be retained and entry to the procedure simplified to enable directors to place a company immediately into liquidation. Where an enterprise is not viable, the law should allow for its swift and efficient liquidation to maximise recoveries for the benefit of creditors.

RECOMMENDATION 55

12.34 The Committee recommends that the law be amended so as to permit administrators to apply to a court for an order that a party to a contract may not terminate the contract by virtue of entry by a company into voluntary administration. The court should be satisfied that the contracting party's interests will be adequately protected.

RECOMMENDATION 56

12.45 The Committee recommends that the Government review the appropriateness of the restriction on a liquidator's powers to compromise debts due to the company where the debt exceeds $20,000.

RECOMMENDATION 57

12.53 The Committee recommends that consideration be given to repealing s 506(4) and replacing it with a provision in similar terms to ss 451A and 451B (concerning the appointment of two or more administrators) i.e. where more than one liquidator is appointed, their functions or powers should be able to be exercised by any one of them, subject to the resolution or instrument appointing them providing otherwise. Consideration should also be given to similar provisions being included in Parts 5.2 and 5.6 of the Corporations Act dealing with receiverships and windings-up generally.

RECOMMENDATION 58

12.72 The Committee recommends that the Government support a program of research into the impact of insolvency procedures, if necessary, by providing a specific allocation for the conduct of such research by ASIC, the professional associations and/or commissioned researchers.

RECOMMENDATION 59

12.84 The Committee recommends that the Government ensure, particularly when contemplating changes to the law, that the two streams of Australia's insolvency laws, personal bankruptcy and corporate insolvency, harmonise where possible.

RECOMMENDATION 60

13.8 The Committee recommends that Australia adopt the UNCITRAL Model Law on Cross Border Insolvency as proposed in CLERP Paper No 8: Proposals for Reform—Cross-Border Insolvency.

RECOMMENDATION 61

13.13 The Committee recommends that the Government play an active role in multilateral forums and international initiatives to strengthen countries' insolvency systems and develop sound practices and principles for insolvency systems taking into consideration differing national legal systems and economic circumstances.

RECOMMENDATION 62

13.33 The Committee recommends that the Government examine the problem of cross border insolvency involving the misappropriation of company funds with a view firstly to preventing such activities (improved reporting on the financial affairs of a company, more effective monitoring and enforcement of requirements to keep records and the more effective use of restraining orders in respect of company assets) and secondly to holding those responsible for missing funds or assets accountable for the losses.

RECOMMENDATION 63

13.34 The Committee recognises that cross-border insolvency and the bankruptcy of those associated with the financial transactions of a failed company are often interlinked. The Committee recommends that any measures taken in either the Corporations Act or the Bankruptcy Act to effect the recovery of debts or to punish the perpetrators of fraud involved in cross-border insolvency take account of how the laws may interact.

CHAPTER 1

INTRODUCTION

Establishment of the Inquiry

1.1 On 14 November 2002, the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into and report on the operation of Australia's insolvency and voluntary administration laws. Under the terms of reference, the Committee was to consider:

(a) the appointment, removal and functions of administrators and liquidators;

(b) the duties of directors;

(c) the rights of creditors;

(d) the cost of external administrations;

(e) the treatment of employee entitlements;

(f) the reporting and consequences of suspected breaches of the *Corporations Act 2001*;

(g) compliance with, and effectiveness of, deeds of company arrangement; and

(h) whether special provision should be made regarding the use of phoenix companies.

Conduct of the Inquiry

1.2 On 27 November 2002, the Committee, in national advertisements, invited interested persons and organisations to make submissions addressing the terms of reference. The closing date for submissions was 31 January 2003. On 26 March 2003, the Committee renewed its invitation for submissions and extended the closing date for the receipt of submissions to the end of May 2003 or soon thereafter.

1.3 In May 2003, the Committee released an Insolvency Issues Paper. It provided background material and information on aspects of insolvency law that had been highlighted in submissions and/or in media and professional commentary on corporate insolvency law and practice. The paper also provided a valuable reference point in generating debate about the many suggestions for reform and posed important questions for consideration by both the Committee and witnesses in preparing for the series of public hearings.

1.4 In the course of its inquiry, the Committee received 58 submissions. A list of the submissions is set out in Appendix 1. Forty five submissions were made public. In

addition to inviting written submissions, the Committee notified various academics, organisations and professionals of its inquiry.

1.5 Apart from the material provided in written submissions and in oral evidence, the Committee drew on a range of information and recommendations contained in reviews and inquiries conducted by other committees having responsibility for the development of corporate insolvency law and policy. It also referred to professional commentary on the subject of its inquiry. Where appropriate the report makes reference to these reviews, inquiries and commentary.

1.6 During 2003, the Committee held hearings in Toowoomba on 23 May, in Canberra on 26 June, 14, 19 and 20 August and 17 September, in Melbourne on 7 and 8 August and in Sydney on 11 and 12 November. Details of the hearings and witnesses who appeared at them are contained in Appendix 2. Hansard transcripts of evidence taken at the hearings were made available on the Parliament House website.

Background to Australia's corporate insolvency laws

1.7 The last major review of Australia's corporate insolvency laws was undertaken in 1988 by the Australian Law Reform Commission (ALRC). Its report—the Harmer Report—was implemented by the *Corporate Law Reform Act 1992*. That Act revised the corporate insolvency laws generally and introduced a new voluntary administration scheme and insolvent trading prohibition. As may be expected with the introduction of a major new procedure in corporate insolvency law the initial period of operation is a testing time as it is during that period that flaws and inefficiencies will be revealed. It is timely and appropriate for a review of the framework governing corporate insolvency proceedings to be undertaken now a decade after the implementation of the Harmer Report.

1.8 In 1999, the Government indicated that it proposed to conduct a broad based review of the operation of Australia's corporate insolvency laws.[1] However, other corporate law reform initiatives appear to have delayed consideration of such a review.

1.9 The Committee notes that a number of separate reviews and inquiries into the law and policy underlying corporate insolvency have been undertaken by various bodies since the implementation of the Harmer Report in 1992 or are currently in progress. The findings and recommendations of these reports are yet to be considered or implemented by the Government. They include the 1997 *Review of the Regulation of Corporate Insolvency Practitioner*s,[2] a 1998 research paper commissioned by the Australian Securities Commission, *A Study of Voluntary Administrations in NSW*[3], the

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1 The Hon Joe Hockey, Minister for Financial Services and Regulation, Speech: *Insolvency Systems in Asia: An Efficiency Perspective*, Hotel Intercontinental, 30 November 1999, Sydney.

2 A copy of the review is available from the Treasury website at http://www.treasury.gov.au/contentitem.asp?pageId=&ContentID=295.

3 A copy of the paper is included as an attachment to submission 24.

1998 *Report of the Legal Committee of the Companies and Securities Advisory Committee on Corporate Voluntary Administration*[4], and the May 2000 *Report of the Companies and Securities Advisory Committee on Corporate Groups*[5] (approximately half of the recommendations in this report relate to insolvency law). The 1993 Report of the ALRC on *Personal Property Securities* (ALRC Report No 64), the 1996 Report of the ALRC on *Legal risk in international transactions* (ALRC Report No 80) and the 2002 Report of the ALRC on *Federal Civil & Administrative Penalties in Australia* (ALRC Report No 95) also considered aspects of insolvency law and policy.[6]

1.10 The Committee also notes that the Government has foreshadowed the adoption of the UNCITRAL[7] Model Law on Cross-Border Insolvency in the Corporate Law Economic Reform Program (CLERP) 8 discussion paper released in October 2002.[8] The Cole Royal Commission into the Building and Construction Industry recently examined the incidence of fraudulent phoenix company activity in the industry and made a number of recommendations in respect of such activity.[9]

1.11 Finally, the Corporations and Markets Advisory Committee (CAMAC) is currently conducting an examination of issues concerning the rehabilitation of large and complex enterprises in financial difficulties. In September 2003, it issued a public discussion paper on the subject of its inquiry. The Advisory Committee is considering issues such as possible changes to the voluntary administration provisions to better accommodate large corporate recovery cases, possible changes to the scheme of arrangement provisions to accommodate these cases and the desirability of Australia adopting a debtor in possession corporate rescue regime along similar lines to Chapter 11 of the United States Bankruptcy Code.[10]

1.12 Two of the above reports are especially noteworthy and relevant to the inquiry as they overlap the Committee's terms of reference and provide a carefully considered perspective on many of the issues raised in submissions to the Committee. They are

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4 The report may be viewed at www.camac.gov.au.

5 The report may be viewed at www.camac.gov.au.

6 Copies of these reports are available from http://www.alrc.gov.au/.

7 United Nations Commission on International Trade Law.

8 A copy of the CLERP 8 Paper is available from the Treasury website at http://www.treasury.gov.au.

9 See *Final Report of the Royal Commission into the Building and Construction Industry*, February 2003: Volume 8, Reform—National Issues Part 2, Chapter 11 Payroll Tax Obligations —Non-compliance, Chapter 12 Phoenix Companies; Volume 9, Reform—National Issues Part 3, Chapter 16 Taxation Obligations—Evasion. The report may be viewed at http://www.royalcombci.gov.au.

10 Corporations and Markets Advisory Committee, Rehabilitating large and complex enterprises in financial difficulties, Discussion Paper, September 2003. A copy of the Discussion Paper is available from the website of the Corporations and Markets Advisory Committee (www.camac.gov.au).

the 1997 *Review of the Regulation of Corporate Insolvency Practitioners* and the 1998 *Companies and Securities Advisory Committee Report on Corporate Voluntary Administration.* Many submissions understandably made reference to these reports. The recommendations of these reports are included in Appendix 3.

Committee's approach

1.13 The Committee accepts that some of the above reviews traversed and in some cases examined in greater depth specific matters dealt with in this report. Nonetheless, it considers that the weight of evidence taken during the inquiry was of sufficient substance to warrant further close consideration of a number of matters dealing with corporate insolvency and for the Committee to formulate recommendations. Where issues and concerns overlap with those considered in previous reports it has, where appropriate, had regard to the findings in these reports.

1.14 During its inquiry, the Committee sought to provide interested parties with an opportunity to comment on matters of concern they may have about the operation of Australia's insolvency laws and the policies underlying those laws. In its inquiry, the Committee has been guided by the issues and concerns highlighted in submissions received by the Committee and the oral testimony of witnesses. It aims to complement the work of the above reviews and at the same time provide an outline of the range of current public concerns about the operation of Australia's corporate insolvency laws.

1.15 The Committee received written submissions and heard evidence from business representatives, individual insolvency practitioners, professional associations, creditors, bodies representing the interests of secured creditors, employees, trade unions, regulators, lawyers, accountants, turnaround practitioners, teachers of corporate law, credit associations, credit insurers and Commonwealth Government departments and authorities.

1.16 The quality of submissions and oral evidence received by the Committee, particularly from insolvency practitioners and teachers of insolvency law, demonstrated a high level of expertise in, and knowledge of, a technical and complex subject. Witnesses appearing before the Committee were concerned to improve the integrity, accountability and efficiency of Australia's insolvency laws in the public interest. Individuals and representative associations were forthcoming in what they considered to be shortcomings and failings in the operation of the law but also in what they considered to be working well and how the law may be improved.

1.17 Receiverships and liquidations are longstanding and more settled forms of administration. In contrast the voluntary administration (VA) procedure is a relatively new and increasingly popular form of administration. Submissions, and consequently the Committee, have focused on evaluations of this new procedure and suggestions for optimising its usefulness for Australian businesses encountering financial difficulties.

1.18 In its inquiry, the Committee has not especially focused on the application of the law to large and complex enterprises though some submissions referred to the issue. Current insolvency law applies to 'companies' generally, large and small, and

most submissions appeared to accept this as a starting premise. The Committee has also made this assumption but recognises that many of the issues considered in this report may lend themselves to different consideration if separate provision is to be made for large and complex enterprises. It notes that this is a particular focus of the abovementioned inquiry by the Advisory Committee and awaits its findings.

1.19 The Committee has not undertaken any empirical research itself and notes the lack of basic data on the operation of those laws. As one submission pointed out:

> There is little data on the operation of insolvency laws in Australia. We have only the bare minimum of information on the operation of our various corporate administrations. There is for example virtually no data on the operation of the voluntary administration procedure beyond the number of commencements.[11]

1.20 This is not a new observation. The Harmer Report expressed concern about the lack of pertinent statistical information on insolvency and put forward a number of proposals to improve information in relation to insolvent companies. The Committee has made some suggestions for enhancing the collection of statistical information about the impact and experience of insolvency.

Structure of the Report

1.21 The Committee does not seek to re-appraise the whole of, or seek to reformulate, the law of corporate insolvency. It has in the main sought to respond to the range of concerns about the operation of insolvency law that have been brought to its attention in submissions and by witnesses. The report includes thirteen chapters corresponding closely to the Committee's eight separate terms of reference.

- Chapter 2 surveys the statutory and administrative context of insolvency proceedings in Australia;
- Chapter 3 considers the appointment, removal, functions and qualifications of administrators and liquidators;
- Chapter 4 considers the duties of directors in an insolvency context;
- Chapter 5 assesses the operation of the voluntary administration scheme over the decade of its operation and contrasts it with the US model;
- Chapter 6 considers aspects of the rights of creditors under the various insolvency procedures focusing on creditor participation in the VA scheme;
- Chapter 7 examines the cost of external administrations and the problem of assetless administrations;
- Chapter 8 examines the issue of unlawful phoenix company activities;

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11 *Submission* 34, p. 2.

- Chapter 10 examines issues that have been raised concerning the reporting and consequences of suspected breaches of the *Corporations Act 2001*;
- Chapter 9 considers issues relating to the treatment of, and priority afforded to, employee entitlements;
- Chapter 11 considers issues concerning the operation of deeds of company arrangement;
- Chapter 12 addresses technical and other issues raised in submissions that do not fall neatly within the scope of other chapters, but are of continuing importance for the efficient operation of the insolvency system; and
- Finally, Chapter 13 looks at cross border insolvency.

The rights of creditors are the subject of consideration throughout the report.

Acknowledgments

1.22 The Committee expresses its appreciation to all those who contributed to the inquiry in preparing and lodging submissions, providing relevant information or appearing before the Committee. It hopes that the findings of this inquiry together with the recommendations of other bodies referred to in this report will assist the Government in ensuring that Australian insolvency law plays its vital role in contributing to Australia's economic progress and stability.

Insolvency law reform—principles

1.23 The Committee is of the view that for the law to remain effective the process of analysis, criticism and reform must be on-going. Major reviews of aspects of the law of corporate insolvency have been undertaken at public expense, notably in 1997 and 1998. The findings of these reports have not to date been implemented. The Committee commends the injunction of the World Bank:

> Because society is constantly evolving, insolvency law cannot be static. The law should be reappraised at regular intervals to ensure that it meets current social needs. Responses to perceived social change involve an act of judgment. The custodians of legal revision and reform should try to identify international best practices and transpose them into the system they oversee, taking into account the realities of the system and available human and material resources.[12]

1.24 The Committee also believes that in view of the strong impetus to the international standardisation of accounting and audit standards that Australia should be alert to the probability that this will be followed by similar standardisation in

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12 World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems,* April 2001, Section 3.1, para. 77.

insolvency and bankruptcy law. As far as practical, further Australian policy development should bear this in mind.

CHAPTER 2

INSOLVENCY—THE STATUTORY CONTEXT

2.1 There are two streams of general statutory insolvency proceedings in Australia, one governed by the *Corporations Act 2001 (Cth)* for companies, and the other by the *Bankruptcy Act 1966 (Cth)* for individuals. Personal insolvency in Australia is dealt with separately under the *Bankruptcy Act 1966.* The objective of bankruptcy legislation is essentially to allow action to be taken by a non-corporate insolvent debtor or their creditors, so that the bulk of the debtor's property can be taken and used to pay creditors in proportion to the amounts owed. Once the procedure has been followed and provided there has been no misconduct on the part of the debtor, the law allows the debtor to be released from the burden of his/her debts and to make a fresh start.

2.2 The focus of the Committee's inquiry is the law governing the conduct of corporate insolvencies, which is principally set out in Chapter 5 of the Corporations Act.[1] In some cases, the insolvency of a company under the Corporations Act may give rise to personal bankruptcy proceedings and Bankruptcy Act implications.[2]

2.3 The Corporations Act came into effect on 15 July 2001 following negotiations between the Commonwealth, States and Territories and the referral of corporations law powers by the States to the Commonwealth in 2001. This Act re-enacted as a single federal law the previous legislative framework for companies legislation contained in eight separate Commonwealth, State and Territory corporations laws (the Corporations Law). The Corporations Act now applies uniformly to corporations across Australia. Corporate insolvency law has been a feature of company law statutes since the adoption of company law in Australia in the 1860s.

The Corporations Act

2.4 The provisions of the Corporations Act that deal with corporate insolvency are primarily concerned with efficient procedures for the winding up of companies, the orderly realisation of the available assets of those companies and the equitable distribution of the proceeds to creditors (including employees) and shareholders. They include procedures governing corporate rescue or reorganisation (as an alternative to liquidation) set out in Part 5.3A of the Corporations Act. There are also provisions

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1 Special insolvency arrangements are in place for financial institutions (ADIs) and insurance companies in the *Banking Act 1959*, the *Insurance Act 1973* and the *Life Insurance Act 1995.* The operation of these arrangements has not been the subject of consideration by the Committee.

2 For example, for directors, if negligence in their duties to creditors is proven, or because of personal commitments in guarantees given to the company or creditors of the company, or in the event of civil liability arising for contravention of the insolvent trading provision.

governing the appointment of receivers or other persons who are entitled to assume control over particular assets of the company, the reconstruction of companies, arrangements and compromises with creditors and the voluntary winding up of companies.

The Harmer Report

2.5 In 1988 the Australian Law Reform Commission, in Report No 45 on the *General Insolvency Inquiry* (hereafter the 'Harmer Report'), completed the first major review of corporate insolvency law in Australian history.[3] Recommendations of the Harmer Report were implemented in the *Corporate Law Reform Act 1992,*[4] which included the following major reforms:

- the VA scheme, which gave legislative backing to a procedure in which a company could reach agreement with its creditors to compromise or defer debts that would be set out in a deed of company arrangement—the procedure in Part 5.3A of the Corporations Act became available from 23 June 1993;
- a new regime for setting aside improper transactions ('voidable transactions') in the period prior to the company's liquidation;
- improved insolvent trading provisions;
- modifications of the rules for the ranking of debts for payment in a liquidation (abolition of the ATO's priority for group tax debts, according superannuation entitlements the same special priority as unpaid wages);
- related company liability for the debts of insolvent subsidiaries; and
- reforms to the winding up and receivership provisions (simplifying the procedures for statutory demands, extending the receivership provisions to agents of mortgagees, imposing a duty on receivers to exercise reasonable care in the sale of company assets).

2.6 Since 1992 the following changes have been made to Chapter 5:

- amendments to Part 5.3A to clarify that debts incurred by a company under a deed of company arrangement were able to be proved in a subsequent winding up (made by the *Corporations Law Amendment Act 1997*);
- consequential amendments to various provisions of Chapter 5 necessitated by the rewrite of provisions on the formation of companies, members'

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3 A copy of the report is available from http://www.alrc.gov.au/.

4 The corporate insolvency amendments of the Act came into effect in June 1993.

rights, meetings, share capital, financial statements and audit and the deregistration of companies (made by the *Company Law Review Act 1997*);

- amendments to extend the duty of directors not to engage in insolvent trading, to increase protection for employee entitlements and to provide sanctions in relation to agreements and transactions having a purpose of avoiding payment of employee entitlements (made by the *Corporations Law Amendment (Employee Entitlements) Act 2000*); and
- amendments to the voidable transactions provisions to permit liquidators to reclaim unreasonable director-related payments and transfers of property made to directors by their companies up to 4 years prior to liquidation (made by the *Corporations Amendment (Repayment of Directors' Bonuses Act) 2003*).

2.7 In response to recommendations of the Cole Royal Commission into the Building and Construction Industry on fraudulent phoenix company activity, the CLERP 9 Bill was introduced into Parliament on 4 December 2003. It proposes amendments to the law to increase the periods for which directors may be disqualified and to expand and clarify the information required to be included in ASIC's register of banned and disqualified directors.[5]

The genesis of modern corporate insolvency law

2.8 Corporate insolvency law took form in the UK in association with the legislation that introduced the limited liability concept and the registered company in the mid-nineteenth century. The modern scheme of winding-up legislation based on the separate legal personality of the company was first established in the *Joint Stock Companies Act 1856* (UK) and included in the consolidating *Companies Act 1862* (UK). The UK Companies Act was progressively adopted by the Australian colonies throughout the 1860s. Up until the adoption of the Harmer Report recommendations in 1992, Australian insolvency law was modelled closely on UK law. While the Harmer Report contributed innovative ideas to Australian corporate insolvency law, it took inspiration from some UK innovations recommended by the 1982 Cork Report (UK), which provides much of the policy foundations of UK insolvency law.

2.9 Prior to 1982, the law dealing with corporate insolvency in the UK developed independently from the law on personal bankruptcy. The Cork Report proposed that a unified insolvency code replace the various laws relating to corporate and personal insolvency, that a unified system of insolvency courts be created to administer the law and that a range of new procedures as alternatives to outright bankruptcy or winding up be introduced to facilitate rescues rather than process failures. The *Insolvency Act 1986* (UK) implemented many of the Cork proposals.

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5 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Schedule 4, Part 2, items 2-4. The Committee is currently inquiring into the provisions of this bill.

2.10 In contrast to the Cork Report, the Harmer Report recognised that there were advantages in having unified legislation but did not recommend a merger of these separate streams of law. Consequently the law dealing with corporate insolvency in Australia has continued to develop independently from the law on personal bankruptcy.

Types of insolvent administrations

2.11 Under Australian law there are broadly three kinds of external administration procedures available to insolvent companies:

- Liquidation or winding up;
- voluntary administration; and
- receivership.

Liquidation

2.12 Liquidation, or winding up, is a procedure by which a corporation is ultimately dissolved. Generally, upon liquidation, the liquidator takes complete control of the corporation from the directors. The objective of a winding up is to bring about an end to the corporation's existence in an orderly and equitable manner that obtains the maximum return possible for creditors and members. The main tasks of a liquidator during a winding up are to:

- collect and sell the company's assets (including any surplus arising from a receivership);
- investigate the company's financial affairs and report to creditors on those affairs;
- report to creditors about unfair payments made by the company before liquidation that may be recoverable and any possible recovery actions against officers of the company for insolvent trading or other wrongful activities;
- report any misconduct in the conduct of the company's affairs to ASIC;
- pay the expenses of the liquidation and certain priority claims including employee entitlements;
- distribute surplus funds (if any) to other creditors; and
- complete the liquidation and apply for deregistration of the company.

Compulsory winding up or official liquidation

2.13 There are different types of liquidation procedures. The most common form of liquidation is a compulsory winding up or official liquidation. A compulsory winding up is effected by an order of the court. It most commonly arises when a creditor petitions a court to have a corporation wound up on grounds of insolvency, relying on failure of the corporation to comply with a demand for repayment of a debt. The liquidator is appointed by the court and is an officer of the court. Only official liquidators are eligible to be appointed.

Members' voluntary winding up

2.14 There is also a members' voluntary winding up procedure and a creditors' voluntary winding up procedure. A members' voluntary winding up is a procedure that can only be used by solvent corporations. No concerns were raised about this procedure in the course of the inquiry.

Creditors' winding up

2.15 A creditors' voluntary winding up may be used where a corporation is insolvent. A corporation may enter a creditors' voluntary winding up where the directors are unable to make a declaration of solvency or where a declaration is made but it later becomes apparent that the company is not solvent. On the same day, or the day after, the meeting of members to consider a special resolution to wind up the corporation, a creditors' meeting is held. The creditors may nominate a liquidator but if the nomination differs from the nomination of members, the creditors' choice will prevail.

Provisional liquidation

2.16 There is also provision in the law for the provisional liquidation procedure. A provisional liquidation commences with an order of a court upon the application of a creditor, director, shareholder, or some other party who has an interest in the company's affairs. An order is generally made by the court in circumstances where there is a winding up application in process and there is a concern that assets of the company may be lost, removed or dissipated, or the company's business may be adversely affected or the value of the business reduced. The appointment of a provisional liquidator allows control of the company to be moved quickly from the directors to an external administrator and investigations to be carried out.

2.17 A provisional liquidator's role is to secure the assets of the company, investigate the company's affairs in order to determine whether the company is solvent or insolvent and provide a report to the court recommending whether the company should be released from provisional liquidation or placed into liquidation or voluntary administration. To do this, the provisional liquidator will ascertain the assets and liabilities of the company and assess its future prospects. This process may take a month or longer.

2.18 If the provisional liquidator is of the view that the company is solvent and the Court agrees, then a strategy will be put in place to return the company to the control of the directors with as little interruption to the business as possible. He/she may also place the company into voluntary administration. If, on the other hand, the provisional liquidator concludes that the company is insolvent and the Court agrees, then the company will be placed into liquidation. In these circumstances, the winding up of the company's affairs will commence.

Voluntary Administration (VA)

2.19 The primary purpose of the voluntary administration (VA) procedure is to provide a flexible, easily initiated and relatively inexpensive procedure that gives a company the benefit of a debt moratorium. This allows the company to attempt a compromise or arrangement with its creditors aimed at saving the company or the business and maximising the return to creditors. If creditors agree to the arrangement, it will be set out in a deed of company arrangement which binds the company and its creditors. If these attempts fail, the legislation facilitates the transition to winding up.

2.20 The objective of the VA scheme is for the business, property and affairs of an insolvent company to be administered in a way that:

- maximises the chances of the company, or as much as possible of its business, continuing in existence; or
- if it is not possible for the company or its business to continue in existence, results in a better return for the company's creditors and members than would result from an immediate winding up of the company.[6]

2.21 An independent administrator, who must be a registered liquidator, may be appointed to take over the affairs of a company by:

- a majority of the company's directors—where those directors believe the company to be insolvent, or that it is likely to become insolvent at some time in the future; or
- a liquidator or provisional liquidator of the company; or
- a chargee entitled to enforce a charge over the whole, or substantially the whole, of the company's property.

Most voluntary administrators are appointed by directors.

2.22 The administrator's primary task is to investigate the financial position of the company with a view to making a recommendation to a meeting of creditors about what should be done with the company. Having formed such an opinion, the

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6 Section 435A.

administrator is required to call a meeting of creditors to determine the company's future. Generally the meeting will have to be held within 28 days (in the usual case) or 35 days (where Christmas or Easter intervenes) of the administrator's appointment.

2.23 A number of reports and statements must accompany the notice of the meeting, including the details of any proposed arrangement with the creditors recommended by the administrator. The administrator must send the creditors a statement containing opinions as to whether it would be in the interests of the company's creditors:

- to execute a deed of company arrangement;
- for the administration to end; and
- for the company to be wound up.

2.24 The administrator must also send to creditors an opinion as to whether there are any transactions that might be voidable and that might enable a liquidator to recover money, property or other benefits. The creditors may resolve at the meeting to:

- execute a deed of company arrangement;
- terminate the administration; or
- have the company wound up.

2.25 If the creditors decide to enter into a deed of company arrangement the Corporations Act sets out what a deed of company arrangement must contain, although the requirements are extremely flexible. Deeds may take a variety of forms. A moratorium type of deed may provide for the creditors to accept payment at a later time, usually in instalments. A compromise deed may provide for the creditors to accept less than 100 cents in the dollar in full satisfaction of their claims. Such deeds may additionally provide that a third party will make a contribution to the assets of the company. The administrator of the company will become the administrator of the deed of company arrangement unless the creditors resolve otherwise.

2.26 If creditors decide that the company should be wound up rather than enter into a deed of company arrangement, the company will be deemed to have entered into a creditors' voluntary winding up and the administrator will be deemed to have been appointed as the liquidator of the company.

2.27 The VA scheme is in effect an interim form of administration which may be invoked by a company pending a determination by its creditors as to its future. It is not a complete insolvency procedure that provides for the ultimate resolution of the affairs of the company. In comparison to other procedures for dealing with companies in financial difficulties, it broadens the options available to creditors.

2.28 Since its introduction the VA scheme has become an increasingly popular form of external administration. It is now the most commonly used form of insolvency administration in Australia. During the twelve months to 31 December 2003 there were 6,661 companies that came under external administration. The following table provides a breakdown of the 6,661 companies that came under external administration.

voluntary administrations	40.5% or 2,699 of all new appointments
court appointed liquidations	33.5% or 2,235 of all new appointments
creditors' voluntary liquidations	19% or 1,268 of all new appointments

These figures do not include companies that were previously in voluntary administration. A review of the 6,208 appointments made in 2002 indicates a similar breakdown with voluntary administrations accounting for 37.4% (2,319) of appointments in that year.[7]

Receivership

2.29 A receivership is usually instituted when a secured creditor appoints an insolvency practitioner as receiver to enforce a security. The receiver acts primarily for that creditor’s benefit. A receivership may be general when the property constituting the security is the company’s business and the whole, or substantially the whole, of its property. Or it may be particular when a receiver is appointed to take control of a particular piece of property and there is no reason for the directors to relinquish direction of the company’s affairs.

2.30 A general receivership sometimes results in the secured creditor being paid and control of the company being restored to its directors. In practice, in most cases the company is beyond rescue and has to be wound up in the interest of the creditors.

2.31 Australian law also allows other controllers to enforce a security. Controllers are subject to some of the duties imposed by the law on receivers. A controller may be the secured creditor itself enforcing the security for itself or an agent for the secured creditor. A receiver is also a manager (that is, a receiver and manager) if he/she has power to manage the affairs of the corporation as well as take possession of particular items of property.

2.32 Receivers, receivers and managers and other controllers are ordinarily appointed by secured creditors where the debtor corporation defaults on covenants set out in security documents. Their role is usually to take possession of certain property in which the creditor has an interest, with a view to using or disposing of the property

7 ASIC Insolvency Statistics: see www.asic.gov.au.

in order to obtain the maximum possible return for the secured creditor. Receiver and managers are more commonly appointed than receivers.

2.33 Floating charges commonly provide for the security interest to encompass the whole of the corporation's assets and undertaking. Under such securities, the secured creditor will usually be entitled to appoint a receiver and manager who has wide powers to deal with the property and the affairs of the corporation concerned.

2.34 Privately appointed receivers are officers of the debtor corporation. They act in the interests of the secured creditor who appoints them. They are not responsible for distribution of any surplus assets. Distributions of surplus assets to unsecured creditors will usually be undertaken by a liquidator who may be appointed at the same time. The liquidator does not have control over the secured property. If the liquidator or the court approves, the receiver may carry on the corporation's business during the winding up instead of the liquidator.

Scheme of arrangement or reconstruction

2.35 The Committee notes that a further procedure is provided for under Part 5.1 by which a corporation may enter into a legally enforceable scheme of arrangement or compromise with its creditors. The procedure is rarely used.

2.36 A scheme of arrangement may allow a company to reach an enforceable agreement with its creditors (and possibly its members) that modifies the legal rights of secured and unsecured creditors or alleviates the company's financial difficulties. It may avoid an impending insolvency administration or replace an existing administration. This arrangement or compromise must be approved by creditors at meetings duly convened in accordance with the Corporations Act and sanctioned by order of a court. An application to the court to order the necessary meetings to consider a scheme of arrangement or compromise may be made by the corporation, a creditor, a member or a liquidator.

2.37 Since the introduction of the voluntary administration scheme, schemes of arrangement have been used rarely, if ever, for the sole purpose of effecting compromises with creditors. They are seen as being time consuming and costly. The scheme of arrangement provisions may also be used for non-insolvency purposes involving members' rights such as reconstructions or mergers which involve a variation of share structures or amalgamations. A scheme of arrangement may be more suitable than other forms of external administration in those particular circumstances.

2.38 As the Corporations and Markets Advisory Committee is currently examining the scope and application of the scheme of arrangement provisions for the rehabilitation of large and complex enterprises it is not proposed that they be the subject of detailed comment in this report.

The General Employee Entitlements and Redundancy Scheme

2.39 An important element of Commonwealth arrangements for the protection of employee entitlements in the event of employer insolvency is the General Employee Entitlements and Redundancy Scheme (GEERS), which protects the entitlements of employees whose jobs have been terminated due to their employer's insolvency. The scheme is considered in chapter 9.

Institutional arrangements

2.40 The following section briefly discusses the role of other institutions in the development and administration of Australia's insolvency laws.

The Australian Securities and Investments Commission

2.41 The Australian Securities and Investments Commission (ASIC) is Australia's national corporate regulatory body. It is responsible for the administration of Australia's corporate laws including its corporate insolvency laws. It may investigate complaints against companies, their officers and insolvency practitioners and initiate proceedings for breaches of the law. Such proceedings may involve prosecutions, civil penalty orders, banning orders, negotiated settlements and enforceable undertakings.

2.42 In Australia, the administration of corporate insolvencies is carried out by private sector practitioners. Compliance with the requirements of the Corporations Act is supervised by ASIC. It is empowered under the Corporations Act to set educational and experience requirements for insolvency practitioners. It may investigate complaints against insolvency practitioners. However, it will not usually become involved in matters of commercial judgment or step into the shoes of the administrator.

2.43 ASIC may take disciplinary proceedings against registered liquidators before the Companies Auditors and Liquidators Disciplinary Board (CALDB). If the CALDB determines that a liquidator has breached the Act, it can apply penalties ranging from a reprimand to suspension or cancellation of the liquidator's registration. The CALDB does not impose fines.

The Treasury

2.44 The Department of the Treasury provides advice to the Australian Government on policy issues and the legislative framework for the development and operation of Australia's corporate laws including corporate insolvency laws but it has no direct involvement in corporate insolvency administration.

The courts

2.45 The courts have general supervisory powers in relation to corporate insolvency administrations and the conduct of corporate insolvency practitioners.

Underlying policies of insolvency law

2.46 The policies and values that underlie insolvency law are rarely explicit in the black letter laws that give expression to the choices legislatures make. Yet they are fundamental in developing a coherent and efficient insolvency regime that is appropriate to the magnitude and nature of the problems it seeks to address, and for justifying the policy choices taken and defending them against alternatives.

2.47 It is important in a broad based inquiry into insolvency to acknowledge at the outset some of the key principles, policies and assumptions that have informed and influenced the design and content of Australia's insolvency laws, and the insolvency laws and systems of comparable countries. They provide a basis for evaluating the current law and suggestions for reforms made in this and other reports. Vanessa Finch of the London School of Economics and Political Science has written:

> It is impossible to evaluate areas of the law, suggest reforms or develop the law with a sense of purpose unless there is clarity concerning the objectives and values sought to be furthered.[8]

2.48 The content of insolvency law is influenced by multiple and even competing objectives relating to a variety of goals, rights and interests. Moreover, the policies that drive insolvency law are not static. They evolve and over time encompass other considerations. The professional literature on corporate insolvency in common law countries is rich in insights into, and critical analysis of, the motivations for, and policies driving, insolvency law. The Committee has had regard to the following sources, which are of necessity selective and limited, for guidance.[9] It will where appropriate make reference to these aims and objectives of insolvency law in assessing suggestions for improvements in the law.

The Harmer Report

2.49 The Harmer Report considered that the fundamental purpose of an insolvency law was 'to provide a fair and orderly process for dealing with the financial affairs of insolvent individuals and companies'.[10] Other objectives cited in the report include:[11]

- insolvency law should provide mechanisms that enable both debtor and creditor to participate with the least possible delay and expense;

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8 Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles,* Cambridge University Press, (2002), p. 1.

9 See for example Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* Cambridge University Press, (2002).

10 ALRC Report No 45, para. 33.

11 ALRC Report No 45, para. 33. For a critique of the Harmer Report "Principles" see Roman Tomasic and Kerurah Whitford, *Australian Insolvency and Bankruptcy Law*, 2nd edition, Butterworths, pp. 4-12 and O'Donovan J, *Corporate Insolvency: Policies, Perspectives and Reforms*, (1990) 3 *Corporate and Business Law Journal* 1.

- insolvency administration should be impartial, efficient and expeditious;

- the law should provide a convenient means of collecting or recovering property that should be applied toward payment of the debts and liabilities of the insolvent person;

- the principle of equal sharing between creditors should be retained and in some areas reinforced;

- the end result of an insolvency administration should be the effective relief or release from the financial liabilities and obligations of the insolvent;

- insolvency law should, so far as is convenient and practical, support the commercial and economic processes of the community;

- as far as is possible and practicable insolvency law should harmonise with the general law;

- insolvency law should enable ancillary assistance in the administration of an insolvency originating in a foreign country.

World Bank Principles and Guidelines

2.50 It is worthwhile noting in this context the perceptions of international institutions as to the pre-requisites for modern and effective insolvency and creditor rights systems.

2.51 In April 2001, the World Bank issued a comprehensive statement of the *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* in the context of ongoing international efforts to strengthen and reform the global financial system and in response to the 1997-98 financial crisis in emerging markets.[12] The *Principles and Guidelines* represent a distillation of international best practice in the design of insolvency systems. In all, 35 principles are put forward. They outline the key features and policy choices necessary to consider in the design of a legal framework for corporate insolvency and an informal framework for consensual debt workouts, and the key features of the supporting institutional and regulatory framework. They highlight the relationship between the cost and flow of credit (including secured credit) and the laws and institutions that recognise and enforce credit agreements. Some of the notable policies of the *Principles and Guidelines* include:

- A modern credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by

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12 World Bank, *Principles and Guidelines Effective Insolvency and Creditor Rights Systems*, April, 2001 available at http://www.worldbank.org/ifa/ipg_eng.pdf.

efficient mechanisms outside of insolvency as well as by a sound insolvency system. Both mechanisms must work in harmony.

- An efficient system for enforcing debt claims is crucial to a functioning credit system, especially for unsecured credit.

- Business and commerce encompass a system of commercial relationships that are predicated on express or implied contractual agreements between an enterprise and a wide range of creditors and constituencies. The rights arising from these relationships enable parties to rely on contractual agreements that foster confidence, which in turn fuels investment, lending and commerce. Uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of non-performance or leads to credit tightening.

- The legal framework should provide efficient, transparent and reliable methods for recovering debt.

- The legal framework should provide for the creation, recognition and enforcement of security interests in all types of assets.

- The integrity of the insolvency system is the linchpin for its success. Strong institutions and regulations are crucial to an effective insolvency system.

Other Reports

2.52 The Cork Report, which provides much of the policy rationale for UK insolvency law, and a recent review by New Zealand of its insolvency laws also make a valuable contribution to the understanding of the objectives of good insolvency laws. They are set out in Appendix 4.

The Committee's approach

2.53 The Committee appreciates that a wide range of policies and objectives must be taken into consideration in the design of an insolvency law. An effective insolvency regime must achieve a careful balance of multiple and even conflicting policies and objectives. In its approach to the range of issues it has had to consider, the Committee has placed importance on the following objectives and values:

- encouraging early intervention in the affairs of companies in financial difficulties and restoring companies to profitable trading where practicable;

- striking a balance between voluntary administration and liquidation;

- protecting the interests of creditors and, in particular, employees in circumstances of financial difficulty and corporate malpractice;

- maximising the value of an insolvent company's assets;

- reducing the cost of credit; and
- encouraging the good management of companies and deterring malpractice and, in particular, abuses of the corporate form and insolvency procedures generally.

2.54 The foremost objective, in the Committee's view, is to promote and maximise trust and confidence in the operation of insolvency law on the part of the community in general and the business and corporate sector in particular.

2.55 This chapter has outlined the statutory and institutional context that is broadly the subject of the Committee's inquiry. The following chapter will consider a key feature of the institutional arrangements that underpin the insolvency system—the role played by those who administer insolvencies.

CHAPTER 3

THE APPOINTMENT, REMOVAL, FUNCTIONS AND QUALIFICATIONS OF ADMINISTRATORS AND LIQUIDATORS

3.1 Insolvency processes are, by any measure, complex and elaborate procedures that diverge markedly from normal commercial and business patterns. Corporate insolvency proceedings can affect employees, suppliers of goods and services, banks and financial institutions, customers and users, shareholders, other providers of capital, guarantors, directors, managers and the debtor itself. The interests and rights of the parties may conflict in a variety of ways.

3.2 But there is a wider dimension to insolvency that extends beyond the immediate parties. Because it almost invariably involves financial loss, there is a public interest in ensuring that the economic adversity of insolvency is limited, resources are efficiently re-allocated to more productive uses and confidence in the workings of fair and efficient markets and the corporate sector is maintained. There is also the desire to ensure that the business is given every chance of success and misconduct on the part of debtors and directors in causing or contributing to the insolvency is uncovered and pursued.

3.3 The sweeping effect of insolvency and the array of legal and administrative, formal and informal rules, policies and practices that it invokes requires that those who are responsible for the administration of insolvencies display the highest standards of honesty, competence, skill and diligence. The success and durability of any insolvency system is dependent on those who administer it.

The role of the administrator

3.4 Every major review of the policies that underpin insolvency law has emphasised the role that insolvency administrators play and the need to ensure they are competent to exercise the powers given to them and act with integrity, impartiality and independence. The World Bank's *Principles and Guidelines* makes the point:

> Those who administer insolvencies—whether appointed by creditors, the court, a government department or agency, a public or statutory authority or the debtor—are given powers over debtors and their assets, and they have a duty to protect them and their value. The nature of the appointment in some jurisdictions is seen as that of, or closely resembling, a trustee exercising public interest powers and undertaking functions [for the] benefit of the creditors and the debtor.[1]

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1 World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, April, 2001, see commentary on Principle 35, p. 61.

3.5 In Australia, the nature of the duties of administrators is very much underlined in relation to the voluntary administration procedure, which places less emphasis than comparable country insolvency systems on court involvement in the process. In the VA procedure, the administrator is one of the most important actors. He/she exercises extensive powers over insolvent companies and their assets and is subject to a duty to protect them and their value. In the process leading to the decision about the future of the company, the administrator plays a vital role in preparing for, and facilitating the making of, the decision.

3.6 The issues that are considered in this chapter include the independence of administrators, their mode of appointment, the desirability of a code of ethics for insolvency practitioners, a roster system for the appointment of administrators, disclosure of conflicts of interest, limitations on the ability of creditors to remove administrators or liquidators, inducements for the referral of work, registration requirements for external administrators and the dual classification of liquidators.

The statutory framework for insolvency practitioners

3.7 In Australia, the administration of corporate insolvencies is carried out by private sector practitioners. An insolvency practitioner may be a:

- liquidator;
- provisional liquidator;
- receiver, receiver and manager or other controller;
- voluntary administrator or administrator of a deed of company arrangement; or
- scheme manager.

3.8 They must be registered as insolvency practitioners and are subject to strict requirements under the Corporations Act. Their legal responsibilities in any particular case will depend upon the type of administration concerned. Compliance with the requirements of the Corporations Act is supervised by ASIC, which is empowered under the Act to set educational and experience requirements for insolvency practitioners and may inquire into matters concerning an administrator.

3.9 Currently there are two classes of persons who may practice as insolvency practitioners under the Corporations Act—registered liquidators and official liquidators. The registration of liquidators and official liquidators is administered by ASIC.

3.10 Official liquidator status has the higher standing as only official liquidators can undertake court appointed corporate insolvencies. Official liquidators must also be registered liquidators. As at 30 June 2003 there were 832 registered liquidators in

Australia. Of these, 363 were official liquidators.[2] Not all registered liquidators are actively engaged in insolvency work (about 450 are actively engaged).

3.11 The Insolvency Practitioners Association of Australia (IPAA) has over 1100 full and associate members.[3] Not all registered liquidators are members of the IPAA—it is not a prerequisite to being a registered liquidator—but most active liquidators are. Registered liquidators are predominantly accountants and members of accounting bodies. The IPAA estimates that, in terms of registered liquidators, it represents about 85 per cent of practising liquidators.[4]

Independence

3.12 Many witnesses agreed that administrators and liquidators should not be, nor appear to be, puppets of the directors or any of the parties affected by the financial difficulties of the company in question. They must be independent and be seen to be independent. Creditors should, as a matter of course, be aware of any relationship, influence or interest that may affect an administrator's capacity to perform his/her duties impartially.

3.13 In most forms of external administration—voluntary administration, receivership and voluntary winding up—the external administrator is chosen by the creditors, the members or the directors in accordance with procedures set out in the Corporations Act. In the case of a winding up ordered by a court, Part 5.4 or Part 5.4A of the Corporations Act provides for the Court to appoint an official liquidator as the external administrator. The most usual method for choosing a liquidator is through nomination of an official liquidator by the applicant for the winding up order. In some cases the courts may select a liquidator by rotation from the Court's list of official liquidators provided by ASIC.

Appointment of administrators by directors

3.14 A voluntary administrator may be appointed, and an administration commenced, by the board of directors of a company, by a liquidator or provisional liquidator or by a secured creditor holding a substantial charge over company property. Appointment of an administrator does not necessitate an application to a court.

3.15 The usual way in which an administrator will be appointed under the voluntary administration procedure is by directors. The majority of directors appoint the administrator of their choice. A critical question is whether this method of appointment calls into question the independence of administrators.

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2 ASIC annual report, 2002-03, p. 13.

3 *Committee Hansard*, 19 August 2003, p 218.

4 *Committee Hansard*, 19 August 2003, p. 218.

3.16 Problems about the lack of independence of external administrators were commonly expressed in submissions and confidential evidence received by the Committee into the conduct of particular administrations. One submission commented that the increasing popularity of the voluntary administration process (which may be conducted by registered liquidators) and the resultant decline in the number of court liquidations (which may only be carried out by official court appointed liquidators) has brought about an 'ambulance chasing mentality' on the part of insolvency practitioners.[5] Concerns extended to aspects of the process of procuring an appointment as an administrator under the VA procedure and the existence of improper relationships between administrators and other parties.[6] Mr Ian Walker, Minter Ellison, told the Committee:

> The administrators have a range of duties that they have to perform. They are required by law, as fiduciaries, to exercise them impartially. The perception that they will favour one side or other in the process will often come about because of the process of appointment, in terms of where their appointment is sourced, if you like, and who has promoted them as the appointee.[7]

3.17 To the same effect, the Commercial Law Association (CLA) commented that in the case of the voluntary administration procedure conflicts of interest tend to arise by reason of the appointment of the administrator by incumbent management.[8] It summed up an oft repeated theme:

> …it is difficult to overcome the perception among creditors that an administrator is not impartial when appointed and, in cases where a deed fails, that his role as liquidator is to bury his mistakes and/or the wrongdoing of his appointors.[9]

3.18 In the course of the administration of the company's affairs, an administrator may act as corporate adviser, voluntary administrator, deed administrator and finally liquidator. An administrator is often asked by incumbent management to advise on a

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5 *Submission* 6, p. 4; and see David Cowling, Winning the accountant's war, Australian Financial Review, 12 September 2003, 54.

6 *Submission* 6, p. 5; *Submission* 14 and see Discussion Paper Independence of Company Administrators, IPAA Working Party on Administration, March 2001 at http://www.ipaa.com.au/pdfs/independance_company.pdf.

7 *Committee Hansard*, 7 August 2003, pp. 110-111. See also comments by Mr Charles who said that: If the directors are choosing the administrator, they are effectively choosing who is going to take up that position and the level of independence that that administrator may have when they are representing the interests of creditors. The extent of our concern is probably reflected in our submission and it is a perception. We believe that the ongoing integrity of the system would be maintained and improved by ensuring that there is that level of independence. *Committee Hansard*, 26 June 2003, p. 52.

8 *Submission* 41, paras. 1-7.

9 *Submission* 41, para. 9.

company's future. He/she then becomes the administrator. If creditors resolve to enter into a deed of company arrangement (DCA) the administrator becomes the administrator of the deed (unless creditors resolve otherwise). If the company is wound up at the second meeting of creditors or upon termination of the DCA the administrator automatically becomes the liquidator.

3.19 In the CLA's view this situation gives rise to a number of potential clashes. There is scope for conflict between the role of adviser and administrator. An administrator is required to consider the possibility of offences, negligence, or breaches of duty or trust by former or present officers of the company and advise whether any transactions may be set aside.[10] These duties require the administrator to review the actions and conduct of the same persons who may have sought his/her advice prior to the administration. Mr David Kerr told the Committee:

> One of the major benefits of a deed of company arrangement to a director is obviously the avoidance of a claim for insolvent trading. If in fact a company director decides to appoint an administrator who happens to have whispered in his ear prior to the appointment, 'Don't worry, buddy; you'll be right—I'll get this deed up and you won't have to worry about insolvent trading,' there is obviously a potential problem. I am not saying that that is widespread or that it even occurs, but there is a perception out there, I think, among some creditors, that that sort of thing is occurring.[11]

3.20 Not every view expressed in submissions was critical of the level and quality of independence of external administrators. A contrasting range of submissions argued that, while there were perceptions of a lack of independence on the part of director-appointed administrators, the problem was more apparent than real.[12]

3.21 The VA procedure is predicated on the assumption that directors will play a role in the appointment of administrators. Colin Anderson and David Morrison, the current authors of *Crutchfield's Voluntary Administration* [3rd edition], pointed out that the statutory framework of duties and responsibilities for administrators provides strong incentives for administrators to take a constructive role in the procedure that delivers benefits to creditors.[13] While there may be competition for business among insolvency practitioners and suspicions that directors appoint administrators who will procure satisfactory outcomes for them, the structure of the legislative scheme is such that on their appointment administrators have limited further obligations to directors. Instead they have specific, on-going obligations and incentives to focus on the concerns of creditors.

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10 Regulation 5.3A.02.

11 *Committee Hansard*, 11 November 2003, p. 300.

12 *Submissions* 6, 12 and 14.

13 *Submission* 34 and Colin Anderson, *The Australian Corporate Rescue Regime: Bold Experiment or Sensible Policy?*, (2001) 10 International Insolvency Review 81 and *Commencement of the Part 5.3A Procedure*, (2001) 9 Insolvency Law Journal 4.

3.22 Commissioner Berna Collier, ASIC, noted that there are provisions in the law, 'which require insolvency practitioners, when they are acting as liquidators or administrators, to act in good faith and to act in many other ways in relation to their fiduciary obligations'. She cited s 536 of the Corporations Act under which ASIC has power to inquire into the conduct of a liquidator and report any matter to the court which is 'a misfeasance, neglect or omission on part of the liquidator'.[14]

3.23 Jones Condon, Chartered Accountants, cited the range of obligations and measures that arise for administrators on appointment including obligations to comply with technical, commercial and ethical standards, on-going scrutiny of their actions by ASIC and the court and creditor scrutiny especially by experienced creditors.[15] It noted that appointment by a court would be cumbersome and would negate the advantages of a company appointed administrator.

3.24 A number of submissions suggested that notwithstanding the method of appointment of administrators, the policy objectives of the VA process—speed, informality, low cost—were being met. Anderson and Morrison emphasised that issues concerning the appointment of administrators must have regard to the wider context of Part 5.3A:

> The basis of much of the directors' personal liability for insolvent trading and taxation debts is premised on the fact that the board can easily deal with insolvency by moving to appoint an external administrator. If we remove this right or make it more difficult, more expensive, and or slower then it undermines the opportunity to ensure that directors behave responsibly.[16]

3.25 Mr Kerr took a similar attitude. He noted:

> The company's power to choose its own administrator has the potential to colour any such appointment. This is the case whether or not the administrator is truly independent. However, this must be balanced against one of the objectives of the voluntary administration process, that is the timely and inexpensive initiation of the process. Alternative methods of appointment including court and regulatory involvement are likely to be slower and more expensive than the present process.[17]

3.26 Jones Condon noted the concerns raised about the perceived lack of independence by administrators but also concluded that no change to the legislation was necessary.[18] In its view the method of appointment is simple, practical and inexpensive and encourages directors to appoint an administrator as soon as possible if

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14 *Committee Hansard*, 20 August 2003, p. 255.

15 *Submission* 12, p. 2.

16 *Submission* 34, p. 5.

17 *Submission* 6, p. 5.

18 *Submission* 12, p. 2.

there are concerns about potential insolvency. Furthermore, creditors may reverse the decision of the Board. It also pointed out that permitting directors to choose the administrator had another advantage. The Board must have confidence in the person who will be appointed administrator, especially if it has a proposal and the success or otherwise of the company's future rests with the competence of the administrator and the Board's ability and willingness to cooperate with that administrator. Jones Condon raised the question that if directors are not permitted to appoint administrators, who would appoint them?[19]

3.27 In its discussion of the design of the voluntary administration procedure, the Harmer Report responded to concerns about the appointment of an administrator by the board in the following terms:

> All of these arguments [against permitting directors to appoint administrators under the VA procedure] are variations on the theme that the independence of the administrator should be ensured, a proposition with which the Commission agrees. However, the proposed procedure contains sufficient safeguards towards ensuring that independence. The aim of promoting the independence of administrators is addressed by the following features of the procedure:
>
> - the persons eligible to be appointed as administrators will be registered insolvency practitioners, who will be practitioners having appropriate qualifications and experience in insolvency practice;
> - certain persons having a close connection with the company cannot be administrators;
> - the administrators must declare associations with the company and any circumstances which may make it difficult for the administrator to act impartially;
> - the directors cannot remove an administrator; and
> - a lack of independence of an administrator may be a ground for removal of the administrator by the court.[20]

3.28 Part 5.3A adopted all of these features except the third of the above dot points.

3.29 A further factor to consider is that the general law places a high degree of importance on the independence and impartiality of external administrators. The courts have stressed that a liquidator is a representative of the court.[21] The decisions that liquidators make are made under the authority of the court itself. He/she is entrusted with the reputation of the Court for impartial and proper dispatch of duties. No lesser standard in that regard is to be expected of a liquidator than that of a court or

19 *Submission* 12, p. 2.

20 ALRC Report No 45, para. 72.

21 Re Timberland Ltd; CCA v Harvey, [1980] 4 ACLR 259.

a judge.[22] A court will decline to appoint a liquidator if it considers there is an actual or potential conflict between the duties of the liquidator and his/her personal interest or some other duty. It would appear that administrators in line with liquidators are subject to fiduciary duties, in particular duties to act impartially, to avoid conflicts of interest and to act in good faith and for a proper purpose.[23] They are also 'officers' of the company and, as such, subject to the general duties of 'officers' under the Corporations Act.

3.30 In all forms of corporate insolvency, the Corporations Act attempts to ensure that the affairs of the company will be administered by independent, responsible and professional practitioners. It addresses the issue of the independence of administrators and liquidators in a number of provisions. Section 448C disqualifies certain persons from acting as company administrators in certain circumstances. Generally those circumstances include the following:

- the person (or a body corporate in which he/she has a substantial shareholding) is indebted to the company for an amount exceeding $5,000;
- the person is a creditor of the company or a related body corporate for more than $5,000 otherwise than in relation to the external administration of the company;
- the person is an officer or auditor of the company or an officer of a company that is a mortgagee of property of the company;
- the person is a partner, employer or employee of an officer of the company; or
- the person is a partner or employee of an employee of an officer of the company.

3.31 Section 532 similarly disqualifies certain persons from acting as a liquidator of a company. Section 595 prohibits the making of inducements to members or creditors to obtain appointments. The Corporations Act also aims to ensure that the professional standards and skills of insolvency practitioners are high. It makes provision for the registration, qualifications and experience of insolvency practitioners. An administrator and a liquidator must be a registered liquidator.[24] Through the requirement to be registered further standards are imposed.

3.32 The Committee understands that the courts have long set high objective standards for liquidators and administrators. A leading authority on the question of independence is *Commonwealth Bank of Australia v Irving*.[25] In this case an administrator was removed not because of any impropriety as such but because a fair-minded person could reasonably entertain a doubt as to the administrator's capacity to

22 Re Timberland, 4 ACLR 323.

23 Wood v Laser Holdings Ltd, [1995] 19 ACSR 245 at 266.

24 Section 448B(2), 532(1).

25 (1996) ACSR 459.

be independent. Branson J observed that any substantial involvement with a company prior to its administration will disqualify a person from appointment as that company's administrator as 'such involvement will be seen to detract from the ability of the person to act fairly and impartially during the course of the administration'.[26]

3.33 The Committee notes, however, that recourse to the courts is not always a realistic option for parties concerned about the lack of independence in an administrator. Mr Edmund Finnane, CLA, told the Committee:

> I can say from my own experience that I have seen some abuses of Part 5.3A in practice, in circumstances where people appear to have assumed that they can appoint an administrator, do a cheap and nasty deed and nothing will be done about it. Having said that, I have also seen that, when disgruntled creditors take this up with the courts, the courts do not let people get away with much. The problem is that it costs a lot of money to go to court.[27]

3.34 Mr Brian Gillard, CLA, reinforced this view:

> The perception we have is that getting them to court is an expensive process, and a creditor who will take on that step without the support of other creditors et cetera is a fairly brave creditor. We see that as the problem. We are looking for other mechanisms for them to address perceived or real conflicts of interest.[28]

3.35 Professor Keay also understood the concerns of people who see the administrator as, 'not really independent in that he or she has a connection with the directors of the company or the company itself'. He said:

> A number of cases have been heard where this has been shown to be the case. If there is any possible suggestion of bias or improper conduct, the courts have removed somebody, but, of course, that is only where it gets to an application. In many cases, the creditors do not have the energy, time or money to actually initiate proceedings to have an administrator removed. As I said earlier, I think there is no doubt that, where you have the systems that we have, you are going to have some abuse. I do not think we can eliminate it totally. Things are a lot better than they used to be, certainly since we brought in more regulation as to who can act in this capacity. [29]

3.36 Submissions also pointed out that insolvency practitioners are subject to professional independence and 'conflict of interest' standards laid down by their

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26 The standard, though high, is not unrealistically so. The perception of a lack of impartiality or independence must be reasonably held: *Citrix Systems Inc v Telesystems Learning Pty Ltd (In Liquidation)* (1998) 28 ACSR 529.

27 *Committee Hansard*, 11 November 2003, p. 314.

28 *Committee Hansard*, 11 November 2003, p. 316.

29 *Committee Hansard*, 14 August 2003, p. 216.

founding member associations—the Institute of Chartered Accountants or CPA Australia—and, for insolvency practitioners who are members of the IPAA. The IPAA drew attention to its '*Statement of Best Practice: Independence on the Appointment of an Administrator*', which was effective for its members from 1 July 2003.[30]

3.37 The Committee considers that the Harmer rationale for appointment of administrators by directors remains persuasive. It does not recommend that this means of initiating the VA procedure be repealed at this time. The method of appointment of an administrator must be seen in the context of the overall rationale of the VA procedure, which is designed to be capable of swift implementation, and to be as uncomplicated and inexpensive as possible as well as sufficiently flexible to provide alternative forms of dealing with the financial affairs of the company. The procedure is initiated at minimum cost to creditors as a whole as no court application is involved. It is unlikely that commencement by court application will demonstrably improve the process of deciding whether to attempt to save the company or put it into liquidation in terms of reducing the time taken to make a decision or enhancing the prospects of rescue.

3.38 Furthermore, the Committee understands that an independent administrator is appointed to administer the company's affairs and directors play no further part. Creditors have the opportunity to replace the administrator with one of their own choice and to decide collectively the fate of the company. The parties may apply to the court to prevent abuses though the Committee accepts that creditors may not have the resources to exercise their option. Despite these checks and balances to ensure the independence of an administrator, some submissions suggested additional safeguards are needed to enhance the independence of the administrator.

Code of ethics

3.39 One submission advocated the incorporation of a code of ethics for insolvency practitioners in the Corporations Regulations similar to that adopted in the Canadian Bankruptcy and Insolvency Rules.[31]

3.40 As noted above, the Institute of Chartered Accountants, CPA Australia and the IPAA have their own professional codes and standards. However, there is no code of ethics specifically tailored to the circumstances of insolvency practitioners. A statutory code of ethics enforceable by ASIC would have an advantage in that it would apply to all insolvency practitioners. As noted above not all insolvency practitioners are members of the IPAA.

3.41 On the other hand, the design and content of professional codes is ordinarily a matter for practitioners' professional bodies and the marketplace. Consumers of

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30 *Submission* 22B, p. 1.

31 *Submission* 6, p. 8.

insolvency services themselves may exert pressure for the adoption of such codes. While the Committee considers that the adoption of a code of ethics tailored to circumstances of insolvency practitioners and insolvency practice has merit, it is preferable that such codes be developed and promulgated by the professional bodies rather than mandated by law. As noted earlier and discussed further in the following section, many features of the legal and administrative framework promote the adoption of high ethical and professional standards. Under s 1282, ASIC may take into account a wide range of matters including whether the person is a fit and proper person to be registered as a liquidator.

Setting professional standards for insolvency practitioners

3.42 A parallel debate about professional independence standards is currently taking place in relation to auditors in the context of CLERP 9. The HIH Royal Commission gave careful consideration to an appropriate standard of audit independence. It noted that in an audit context there would rarely be unequivocal evidence conclusively establishing a connection between influence exerted by management upon an auditor and the provision by an auditor of an unqualified audit opinion. The existence of such a connection from a range of surrounding circumstances can usually only be inferred and the difficulties associated with identifying a compromise of audit independence are inherent in the nature of the audit process.

3.43 The Royal Commission recommended the adoption of an objective standard of independence, in particular that all standards of independence of auditors should be defined so that an auditor is not independent with respect to an audit client if the auditor might be impaired—or a reasonable person with full knowledge of all relevant facts and circumstances might apprehend that an auditor might be impaired—in the auditor's exercise of objective and impartial judgment on all matters arising out of the auditor's engagement.[32] Mr David Kerr, official liquidator, proposed that the defined standard of independence for auditors recommended by the HIH Royal Commission should be applicable to external administrators.[33]

3.44 The recommendations of the Commission are specifically tailored to audit functions that do not have precise parallels with the functions of an external administration. Proposed Division 3 of Part 2M.4 of the CLERP 9 Bill implements the Ramsay report as discussed and refined in CLERP 9 and relevant recommendations of the HIH Royal Commission Report and sets out a detailed regime of general and specific auditor independence requirements.[34] While useful comparisons may be

32 HIH Royal Commission, *The Failure of HIH Insurance*, Final Report, Canberra, 2003, Recommendation 9.

33 *Submission* 6A, p. 1.

34 Proposed ss 324CA and 324CB are the key provisions establishing the parameters of the general requirements for auditor independence.

drawn between the role of an auditor and that of a liquidator, the Committee considers that the respective roles of auditors and external administrators are different in nature.

3.45 Furthermore, the Committee notes that the legislation already disqualifies persons from acting as company administrators in particular circumstances (see paragraphs 3.29–3.32) and the courts have shown that they have a clear understanding of what might impair a liquidator in exercising objective and impartial judgment on all matters arising out of his or her appointment. The IPAA maintained that the 'concept of independence in situation, attitude and action is well established in all existing legislation, professional codes and literature'.[35] At this stage, the Committee believes that attention should be given to the procedures in place for the appointment and removal of administrators and liquidators.

3.46 The following section looks at a number of suggestions aimed at strengthening the independence of administrators and liquidators through the appointment and removal processes.

A roster system

3.47 The Australian Taxation Office (ATO), which expressed concern that a perceived absence of impartiality may be eroding public confidence in the VA process, advocated consideration of a roster system for the appointment of administrators on a random basis.[36] The CLA also supported a roster system. It proposed that a roster system be considered for the initial appointment of administrators and for the appointment of a liquidator in the event that a deed fails and the company goes into liquidation. Alternatively an administrator appointed by directors should be appointed on an acting basis. If this appointment is not confirmed or another administrator chosen, the administrator should then be chosen from the roster.[37]

3.48 The Harmer Report also considered but rejected a roster system. It stated:

> A roster system would detract from the voluntary nature of the procedure. The quality of administrators would inevitably vary from person to person. The directors may have proposals for dealing with the company's insolvency. In fact, the existence of these proposals may have encouraged the directors to have the company voluntarily submit its affairs to a particular insolvency practitioner. Therefore it is important that the company, at least in the initial stages, should have some freedom of choice in appointing the administrator.[38]

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35 IPAA, *Statement of Best Practice,* see Supplementary Submission 22B.

36 *Submission* 14, p. 3.

37 *Submission* 41, paras. 12-15.

38 ALRC Report No 45, para. 70.

3.49 The 1997 Review of the Regulation of Insolvency Practitioners also did not favour the adoption of a rotation system. It recommended that the system for appointments of corporate insolvency practitioners by the Court be based on nomination by the petitioning creditor with a 'back up' rotation system if the nomination is not or cannot be made successfully. The Court should be given power to reject a nomination on its own motion or on the application of an interested party.

3.50 Some witnesses were similarly critical of a rotational basis of appointment, particularly its lack of flexibility in allowing the appointment of an expert in the relevant business.[39] Anderson and Morrison commented:

> …it is difficult to see how this would work in practice where there is a need for a quick appointment. Also it may be counter productive in that there would be no natural selection of those administrators who perform their tasks best or who possess the best skills in relation to a particular industry. Also any proposal that suggests that the appointment should be by the court needs to justify the costs of court applications.[40]

3.51 Mr Anthony D'Aloia, Partner, D'Aloia Handberg, was also critical of a roster system:

> The Supreme Court has had a roster system and it has moved away from that. It is cumbersome and you do not get the person that you need or want necessarily.[41]

3.52 Mr Jon Clarke, Law Council of Australia, gave a practical instance of where a roster system would simply not work. He told the Committee:

> For example, you might need an insolvency practitioner specialised in the wine industry but on a roster system you might get somebody appointed as the insolvency administrator who does not know anything about that particular industry.[42]

3.53 The Committee does not consider that a roster or rotation system should be adopted as the main method of appointment of administrators.

Statement of independence

3.54 Previous committees of inquiry have recommended the adoption of a statement of independence which discloses professional, personal or business relationships between the administrator or his/her firm and the company or its officers,

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39 See for example, *Committee Hansard*, Mr Clarke, 14 August 2003, p. 197; Professor Keay, 14 August 2003, p. 217; Mr Carter, 19 August 2003, p. 224; Mrs Arnold, 19 August 2003, p. 229.

40 *Submission* 34, p. 4.

41 *Committee Hansard*, 7 August 2003, p. 119.

42 *Committee Hansard*, 14 August 2003, p. 197.

members or creditors. The Harmer Report in 1988 recommended that an administrator be required to declare 'associations with the company and any circumstances which may make it difficult for the administrator to act impartially'. The Corporations and Markets Advisory Committee also proposed that administrators be required to table a statement of interest at the first meeting of creditors.[43] At this meeting, creditors may appoint another administrator. In the words of QBE Trade Credit:

> This first meeting affords creditors their one and only real opportunity to remove the VA if the creditors suspect that there is not total independence between the Insolvency Practitioner and the company.[44]

3.55 A number of submissions also supported the adoption of a statement of independence. Mr D’Aloia proposed that a statement of independence be sent to creditors prior to the first meeting of creditors, with the correspondence informing creditors of the administrator’s appointment and of the first meeting of creditors.[45] Endorsing the same approach, Mr Ian Walker, partner, Minter Ellison, said:

> I certainly think you can have as clear as possible a declaration of relationships, conflict and so forth…so that the creditors at the time of appointment, or at the first meeting of creditors, or even perhaps before that first meeting, get a very clear statement of the administrator’s prior contacts with the company and are able to form a view about whether those are appropriate…I think you should have full disclosure, bearing in mind that effectively these individuals are going to be fulfilling a task as responsible to and accountable to those parties. They should have confidence in their independence and their capacity to perform their functions.[46]

3.56 Before the Committee, Mr Harmer maintained his support for a statement of independence. He stated:

> I think there should be a positive requirement to make a declaration at the very beginning. That should be a continuing requirement, so that if any circumstance arises, that will immediately impose an obligation for a further declaration. It might be strengthened by providing for greater sanctions where there has clearly not been a disclosure. Rather than the possibility of having your appointment terminated, I think it should be carried further, at least in the professional body that ultimately regulates insolvency practitioners. That is where some greater sanctioning should lie.[47]

3.57 The Committee considers that a statement of independence is an important factor in reinforcing for creditors and administrators the need to safeguard the

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43 Advisory Committee *Report on Corporate Voluntary Administration (1998)*, paras. 6.1-6.9.

44 *Submission* 49, p. 2.

45 S*ubmission* 15, p. 3.

46 *Committee Hansard*, 7 August 2003, p. 112.

47 *Committee Hansard*, 17 September 2003, p. 278.

independence of administrators. It will alert creditors to any possible conflict of interests that the administrator may have and assist them at their first meeting in considering whether or not to remove the administrator. The Committee further notes Mr Harmer's view that there should be a continuing requirement to disclose conflicts of interest.

Recommendation 1

3.58 The Committee recommends that the law should require administrators to make available a statement of independence before the first meeting of creditors disclosing any professional, personal or business relationship between the administrator or his/her firm and the company or its officers, members or creditors. There should be provision for appropriate sanctions for false or misleading statements.

3.59 Further, the Committee recommends that the administrator be under an obligation to disclose conflicts of interest if and when they arise.

Replacement of the administrator

3.60 Once appointed, an administrator may only be removed by creditors at their first meeting and thereafter only by the court on application by a creditor or ASIC. The law provides that an administrator's appointment may not be revoked.[48] This restriction on replacing an administrator serves to reinforce the independence of the administrator. Section 449B permits a court, on application either by ASIC or a creditor, to remove or replace the administrator. The provision does not set out criteria on the basis of which a court may order removal but the principles that have been applied are based on those that apply in relation to the removal of a liquidator.

3.61 There are two milestones, in particular, in the course of an administration when creditors may want to replace an administrator: when the administration ends and the company proceeds into liquidation, and when a deed of company arrangement ends and the company proceeds into liquidation. However, the Corporations Act restricts the right to replace the administrator in these instances. It provides that when the administration ends and the company proceeds into liquidation, the administrator is to be taken to be the liquidator.[49] Similarly, when a deed of company arrangement ends (by creditors resolving to terminate the deed and wind the company up, by a court order terminating the deed or by the deed itself specifying circumstances when it is to be terminated and the company wound up) and the company proceeds into liquidation, the deed administrator is to be taken to be the liquidator.[50]

3.62 The law elsewhere provides that if the creditors decide to enter into a deed of company arrangement, the administrator of the company is taken to be the

48 Section 449A.

49 Section 446A(4)(a)(i).

50 Section 446A(4)(a)(ii).

administrator of the deed, unless the creditors appoint some other person.[51] The provision recognises the right of creditors to replace the administrator. In keeping with this provision, the Committee considers that creditors should have the same right to exercise a choice as to the liquidator they want in the above circumstances. The Committee notes that the Advisory Committee makes a similar recommendation.[52]

3.63 A number of submissions supported the right of creditors to change liquidators in a wider range of circumstances than is presently provided for under the law.[53] The Law Council commented:

> Creditors should have the right to appoint their own nominee as liquidator when a company under administration goes into winding up at the second meeting pursuant to section 439C.[54]

3.64 QBE Trade Credit noted:

> We, as representative of unsecured creditors, would seek that all creditors should have the right to appoint a different person as liquidator in place of the incumbent administrator at the second meeting. This should even extend to when the deed administrator (of a DOCA) seeks to place the company into liquidation on the failure of the Deed at a later date.[55]

3.65 There may be other reasons for seeking to replace the administrator/deed administrator. The CLA notes that there is a potential conflict of interest in the appointment of an administrator by incumbent management and the performance by that administrator of successive functions in the course of the administration.[56] The same individual may, for example, provide pre-administration advice to the company, and also act successively as administrator, deed administrator, and liquidator. A liquidator may need to investigate the manner in which the administrator and deed administrator performed their functions. Under s 533 of the Corporations Act he/she may need to report on any misapplication or retention of property or whether the person may have become liable or accountable for any money or property of the company or guilty of any acts of negligence, default, breach of duty or trust in relation to the company. Where the same person has performed successive functions it may not be possible for a truly independent examination of these matters to be undertaken. In effect, the liquidator is assessing his or her own work and performance.

3.66 Replacing the administrator/deed administrator may increase the overall costs of the liquidation if the new appointee needs to become familiar with the company's

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51 Section 444A(2).

52 Corporate Voluntary Administration Report, Recommendation 54.

53 *Submission* 26, p. 12; *Submission* 49, p. 3.

54 *Submission* 26, p. 12.

55 *Submission* 48, p. 3.

56 *Submission* 41, pp. 1-2.

affairs. It may also cause some delay in winding up the company. Mr Peter Lucas, an official liquidator, commented that making it easy to remove liquidators may only result in insolvency practitioners lobbying creditors to try to remove their competitors in larger administrations, which may not be in the interest of creditors.[57] However, these are matters for creditors to consider.

3.67 In the Committee's view, it is reasonable to allow creditors who have reservations about the objectivity of an administrator to be able to choose another person to be liquidator. Allowing creditors to have an effective say in the appointment and removal of administrators also counters perceptions of a lack of independence and accountability on the part of administrators.

3.68 In this context it may also be noted that a liquidator or provisional liquidator must obtain leave of the court before appointing himself or herself as administrator.[58] The Advisory Committee has recommended that a liquidator should be entitled to appoint himself or herself as administrator with the approval of the creditors of the company or with the leave of the court.[59] The Committee concurs.

Recommendation 2

3.69 The Committee recommends that creditors should be able to appoint a different person as liquidator when the administration ends and the company proceeds into liquidation, and when a deed of company arrangement ends and the company proceeds into liquidation.

Administrator's casting vote in relation to his/her removal

3.70 A number of submissions noted that the method of voting at meetings of creditors and in particular the power of the administrator to exercise a casting vote has relevance for the issue of the independence of administrators. They suggest that one means of enhancing the independence of administrators is to have the administrator's right to a casting vote removed. The method of voting by creditors also has relevance for the rights of creditors and deeds of company arrangement and is discussed in chapter 6. The Committee at this stage confines its consideration to voting on the removal of the administrator.

3.71 The IPAA indicated that it was 'supportive of a change which would prevent an administrator using a casting vote in a resolution in which he or she has a direct interest'.[60] The IPAA gave as one example the use of a casting vote in relation to resolutions regarding his/her removal.

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57 *Submission* 33, p. 2.

58 Section 436B(2).

59 Corporate Voluntary Administration Report, Recommendation 48.

60 *Submission* 22B, p. 4.

3.72 The Committee considers that it is inappropriate for a casting vote to be used in relation to any resolution concerning the administrator's replacement and recommends that the use of the casting vote in such circumstances be prohibited. It understands that the default position will be that the administrator retains his/her position. Under s 449B, ASIC or any creditor of the company may apply to a Court to have the administrator replaced.

Recommendation 3

3.73 The Committee recommends that an administrator should be prohibited from using a casting vote in a resolution concerning his or her replacement.

3.74 The Committee now looks at inducements for referring work before turning to other matters that touch not only on the independence of liquidators but their professional standing and competency.

Inducements for the referral of work

3.75 Mr David Kerr thought that there were 'some loopholes in the present legislation, in that the provisions dealing with inducements do not deal with inducements to directors'.[61] The IPAA expressed the view:

> There may be an issue of some insolvency practitioners offering inducements for the referral of work to other providers of professional services (for example other accounting firms and legal firms).[62]

3.76 It recommended that s 595, which prohibits inducements to members or creditors to obtain or prevent appointments, be extended to include not only members and creditors, but also directors and any other person or entity.[63] The Committee agrees that this is a significant omission from an important provision.

Recommendation 4

3.77 The Committee recommends that the prohibition in s 595—inducements to be appointed liquidator etc. of a company—be extended to include not only members and creditors, but also directors and any other person or entity.

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61 *Committee Hansard*, 11 November 2003, p. 300.

62 *Submission* 22B, p. 1.

63 A person must not give, or agree or offer to give, to a member or creditor of a company any valuable consideration with a view to securing the person's own appointment or nomination, or to securing or preventing the appointment or nomination of some other person, as a liquidator or provisional liquidator of the company; an administrator of the company or of a deed of company arrangement executed by the company; or a receiver, or a receiver and manager, of property of the company; or a trustee or other person to administer a compromise or arrangement made between the company and any other person or persons.

Registration requirements for insolvency practitioners

3.78 The Law Council submitted that the current entry requirements for registration as insolvency practitioners are unjustifiably restrictive.[64] Before considering the Law Council's comments the following section outlines the statutory and administrative regime for the registration of liquidators. While the independence of administrators is essential in maintaining the integrity of the insolvency system, the qualifications and professional standards of practitioners are also of primary importance.

3.79 Part 9.2 of the Corporations Act sets out the requirements for becoming a registered liquidator. There are two forms of liquidator registration granted by ASIC, registration as an 'official liquidator' and registration as a 'registered liquidator'.

3.80 Under the Corporations Act, an application for registration as a (registered) liquidator may be approved by ASIC where the applicant:

- is a member of the ICAA, CPA Australia, or one of a number of comparable bodies in New Zealand, the United Kingdom and the United States;
- holds tertiary qualifications in accounting and commercial law including company law; or
- has other qualifications and experience that in the opinion of ASIC are equivalent to the above qualifications.

3.81 In addition ASIC must be satisfied:

- as to the experience of the applicant in connection with the winding up of bodies corporate; and
- that the applicant is capable of performing the duties of a liquidator and is otherwise a fit and proper person to be registered as a liquidator.[65]

3.82 In applying these provisions, ASIC has indicated that an applicant must have at least five years experience in public practice and experience in external administrations under the direction of an official liquidator for a continuous period of at least three years, including windings-up, receiverships, reconstructions and voluntary administrations. He/she must also have supervised external corporate administrations on a full time basis for at least two consecutive years immediately before the date of the application.[66]

3.83 An official liquidator is a liquidator who has obtained sufficient experience to be regarded as an appropriate appointee in court ordered liquidations. While there are no specific provisions that deal with the criteria for registration as an official

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64 *Submission* 26, p. 8.

65 s 1282(2).

66 ASIC Policy Statement 40.

liquidator, ASIC has power to register a person who is a registered liquidator as an official liquidator.[67] ASIC has the discretion to register as many official liquidators as it thinks fit.

3.84 ASIC has indicated that an applicant for registration as an official liquidator must, in addition to being a registered liquidator, have a minimum of two years' continuous experience after registration as a liquidator in insolvency administration, show involvement in decision making in complex, court-ordered insolvency liquidations, have staff and other resources adequate to conduct an official liquidator's practice, have appropriate training and operational manuals and consent to accept any appointment made by a specified court.[68]

3.85 It is possible for a person to apply to ASIC to be the liquidator of a specific body corporate for the purposes of a 'one off' administration. ASIC may approve such an application where it is satisfied that the applicant has sufficient experience and ability, and is a fit and proper person, to act as a liquidator of the body, having regard to the nature of the relevant insolvency administration. ASIC has issued Policy Statements to explain the criteria it will apply in exercising its discretions in relation to the registration of liquidators.[69]

3.86 The combined effect of the above provisions in the Corporations Act and ASIC guidelines on the registration of liquidators and official liquidators has been that only:

- accountants with corporate insolvency experience under the direct supervision of an official liquidator can become registered liquidators and therefore be eligible to perform corporate insolvency work;
- official liquidators can perform court ordered liquidations; and
- registered liquidators working under the direct supervision of official liquidators can expect to gain the experience necessary to satisfy ASIC’s criteria for registration as official liquidators.

3.87 The Law Council commented that:

> Persons in other professions other than accounting are unlikely to fulfil the entry requirements.[70]

3.88 It considered that lawyers experienced in commercial practice or insolvency law will often have the capacity to undertake liquidation. Just as liquidators will currently seek expert advice on legal matters, so can advice be sought on particular

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67 s 1283(1).

68 ASIC Policy Statement 24.

69 Policy Statement 24: Registration of Official Liquidators; Policy Statement 40: Registration of Liquidators.

70 *Submission* 26, p. 6.

accountancy issues by a liquidator.[71] A strong argument in favour of broadening the criteria is that liquidators are fiduciaries and for lawyers this concept has special significance.

3.89 Generally, corporate insolvency practitioners are appointed to companies that are in financial difficulty or are insolvent. The precise role that the insolvency practitioner plays is diversified and will depend on the type of administration involved. His/her main task is to develop and implement a plan for the recovery of the company after presentation to, and approval by, creditors, or arrange for the winding up of the company in a manner that, as far as possible, maximises the returns to the company’s creditors and members. The skills required are not necessarily or even predominantly those of a traditional legal kind.

3.90 If corporate reconstruction must be considered, insolvency practitioners must review the recovery prospects of the company within its market environment, choose between various possible options for the company’s reconstruction, negotiate approval with creditors and directors, and then implement, manage and monitor the plan. At the same time the administrator must stabilise business operations including the possible financing of operations and manage the day to day operations of the company. Depending on the type of administration, tasks may include unravelling complex financial transactions, continuing a manufacturing business or dealing with stock, commodity or futures market transactions. Critical disputes between parties may need to be resolved and as quickly as possible, especially where these threaten to disrupt the business or prevent the use of assets.

3.91 Where a winding up is involved, an insolvency practitioner must:

- arrange for the orderly realisation, collection and sale of assets of the company, as well as the subsequent disposition of assets to creditors according to their relative priorities; and
- investigate the company's affairs and report on the stewardship of directors and, where necessary, take legal proceedings to recover assets from other parties on behalf of the company.

3.92 The 1997 *Review of the Regulation of Insolvency Practitioners* noted that the tasks of an insolvency practitioner may involve assessing and analysing:

- an industry and its performance;
- the placement and performance of particular products within a market;
- the structure and performance of a company’s resource markets;
- organisational structures within a company;
- management performance and capabilities;
- labour relations and work practices;

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71 *Submission* 26, p.7.

- profitability both in terms of past performance and forecasts of future performance;
- asset structures and valuations, debt and capital structures, cash flows, risk exposure and the prospects of a company being able to obtain finance; and
- likely impacts of future Government policy or regulatory initiatives.[72]

3.93 There will in almost every form of external administration be legal issues to consider. An understanding of the legal aspects of an insolvency procedure is essential for a corporate insolvency practitioner. The legal responsibilities and issues in any particular case will depend upon the type of insolvency administration.

3.94 After comprehensively reviewing the registration requirements under the former Corporations Law, the 1997 Report concluded that there was some scope for broadening the entry requirements to include applicants other that those from the accountancy profession. Persons with various combinations of qualifications and experience should be eligible for registration. The Report recognised that the range of skills and knowledge needed to conduct external administrations is unlikely to be possessed by one person. In such circumstances it is appropriate for the administrator to call on specialists for assistance. The regulatory regime is predicated on the assumption that an insolvency practitioner should be able to obtain expert advice, which he/she lacks, from external sources.

3.95 The Committee agrees with that conclusion. It notes, however, the one prerequisite that most witnesses identified as essential for eligibility to be a registered insolvency practitioner—general management ability.[73] Mr Brian Gillard, CLA, spoke for a number of witnesses when he said:

> I think the touchstone of it is that you need the commercial experience to be able to appreciate the issues. Particularly in relation to being an administrator, you need to see through the proposal that the directors are making and you need to see how that affects all stakeholders in the company. You really need that commercial background.[74]

Recommendation 5

3.96 The Committee strongly endorses the heavy emphasis that ASIC places on practical experience in external administration, especially managerial skills, as a prerequisite for registration as a liquidator and recommends that it should not be weakened. It does, however, recommend that the criteria for registration as an insolvency practitioner be broadened to recognise qualifications in other relevant disciplines including legal practice.

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72 *Review of the Regulation of Corporate Insolvency Practitioners* (1997), p. 17.

73 See comments by Mr Carter, *Committee Hansard,* 19 August 2003, p. 221.

74 *Committee Hansard*, 11 November 2003, p. 313.

3.97 However, it does not consider that any lawyer holding a current unrestricted practising certificate should be able to be registered as a liquidator. Insolvency practice should not be based merely on knowledge of general principles, or general qualifications and experience. It is also important that administrators maintain their knowledge through continuing education or experience that covers the range of insolvency issues at both technical and practical levels. An insolvency practitioner should be able to demonstrate high professional standards, expertise and competencies in relation to the law and practice of insolvency as a prerequisite to registration and on an on-going basis.

3.98 The Law Council recommended that any proposed registration criteria should retain the need for professional membership including a specific requirement that an applicant lawyer should hold a current practising certificate. Mr Gotterson explained the criteria the Law Council had in mind:

> We envisage that lawyers who are experienced in insolvency or commercial practice will be the ones who would qualify as liquidators. This is not a pitch for all lawyers, just because they are lawyers, to be eligible to be liquidators. We acknowledge that there is a need for specific rules about levels of previous experience and the undertaking of specific courses of study in liquidation. Consideration has to be given to those, and we acknowledge they would be part and parcel of any reform. We are concerned that the criteria, when ultimately settled, are not so overly prescriptive as to effectively amount to a barrier to lawyers entering the market.[75]

3.99 The Committee considers that, in the case of lawyers, possession of a current unrestricted practising certificate should be a prerequisite to registration.

Ongoing registration criteria

3.100 Mr Bruce Carter, IPAA, suggested that part of the problem with ensuring high standards is the lack of monitoring. He told the Committee:

> …you get your registration and then it is a matter of monitoring and maintaining your standards thereafter and there is no process in place for that unless something goes wrong. In other words, it is a bit like getting into the English cricket team: once you are in it, it is very difficult to get out of it. With registered liquidators there is no monitoring of what happens going forward.[76]

3.101 The IPAA argued that the professional standards of insolvency practitioners were relevant to the performance of administrators and that consideration should be given to reviewing the educational standards required for registration. It suggested that

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75 *Committee Hansard,* 14 August 2003, p. 191.

76 *Committee Hansard*, 19 August 2003, p. 224.

the criteria for registration as a liquidator or to maintain on-going registration as a liquidator should be strengthened and include the following categories:

- education (initial—IPAA Insolvency Education Program or equivalent—and continuing);
- skills;
- resources;
- membership of an appropriate professional body; and
- experience (initial and continuing).[77]

3.102 The IPAA also proposed that ASIC have a process in place to monitor liquidators to ensure that they continue to meet the criteria.

3.103 The Committee considers that the law should be clarified to ensure practitioners meet on-going registration criteria.

Recommendation 6

3.104 The Committee recommends that the law should provide for procedures to be in place to monitor insolvency practitioners to ensure that they continue to meet on-going registration criteria in regard to education including continuous education requirements, skills, resources, membership of an appropriate professional body, experience and fitness for registration.

3.105 The Committee notes that ASIC has initiated an Insolvency Practitioner Regulation Project, which involves a thorough review of the way insolvency practitioners are regulated.[78] In close consultation with the profession, ASIC will be releasing a policy proposal paper in 2004 for comment. It is also researching the way insolvency practitioners are regulated in comparable jurisdictions. In particular, in relation to the registration of liquidators, ASIC proposes to consider the appropriateness of the tiered system of registration of practitioners, the requirements for maintaining registration and whether the current registration system should be upgraded to a licensing system.

3.106 Commissioner Collier told the Committee that ASIC was looking at 'possibly doing some policy work to build up to a proposal for licensing of insolvency practitioners as distinct from registration'. She explained:

> Licensing is a procedure whereby in order to maintain one's licence one has to continue certain levels of experience, staffing, resources, educational

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77 *Submission* 22A, pp. 5-6.

78 Drysdale, Mark, 'ASIC's Insolvency Practitioner Regulation Project', *Australian Insolvency Journa*l, Oct/Dec 2003, p. 31.

> qualification and so on as distinct from a one-off registration, which is currently the situation…[79]

3.107 The Committee welcomes this initiative and encourages ASIC to develop and pursue its ideas for a licensing system which is a prominent feature of the regulatory regime for financial markets. This has the potential to optimise the public benefits of the statutory framework for insolvency practitioners.

3.108 The Committee suggests that ASIC continue to explore the proposal to introduce a licensing system for insolvency practitioners and consult with those in the industry and with the Government about the matter.

An advisory council

3.109 The Law Council recommended the establishment of a formal mechanism through which a number of professional organisations, including the Law Council, may play an advisory role to ASIC in its regulation, appointment, registration and removal of liquidators, as well as on issues relating to the maintenance of professional independence and integrity of insolvency practitioners.[80]

3.110 The Committee sees some merit in this suggestion. It considers, however, that the statutory disciplinary role, independence, powers and functions (current and proposed)[81] of the Companies Auditors and Liquidators Disciplinary Board should be preserved and be separate and distinct from those of the proposed advisory council. The following recommendation assumes that the criteria for registration will be broadened to allow other professionals including lawyers to become insolvency practitioners as proposed above. A formal advisory council of this kind may be chaired by ASIC.

Recommendation 7

3.111 The Committee recommends that the Government consider establishing an advisory council comprising representatives of professional organisations including the Insolvency Practitioners Association of Australia, CPA Australia, the Institute of Chartered Accountants in Australia, and the Law Council to assist ASIC in relation to the regulation, appointment, registration and removal of registered and official liquidators as well as on issues relating to the maintenance of professional standards of insolvency practitioners.

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79 *Committee Hansard*, 20 August 2003, p. 257.

80 *Submission* 26, p. 8.

81 The *Review of the Regulation of Corporate Insolvency Practitioners* (1997) proposed additional functions for the CALDB, see chapter 8.

The dual classification of liquidators

3.112 The IPAA proposed that there should be a single class of liquidator rather than the current registered and official liquidator status.[82] Arguments in favour of this phasing out of the current dual classification of liquidators include:

- no corresponding dual classification in the personal insolvency framework;
- the current dual classification is an historical development and is now largely outdated;[83]
- the types of administrations in which official liquidators are involved are not necessarily more or less complex or difficult than administrations undertaken by registered liquidators;
- Court ordered liquidations are decreasing and often include cases where there are no assets to distribute.

3.113 Arguments in favour of retaining the dual classification of liquidators include:

- the need to ensure that registered liquidators would be capable of performing court ordered liquidations to the satisfaction of the court;
- most professions recognise different levels of professional experience and skill in one way or another;
- the dual classification is longstanding and the courts may have greater confidence in it than in a single classification; and
- the registration criteria for a single classification would need to be settled before it could be introduced.

Committee view

3.114 The Committee accepts that there are valid arguments both in favour of and in opposition to the proposal for a single class of liquidator. Considering that the present system stems from a long-established convention, it may be time to review the classification of liquidators to determine whether it needs to change to accommodate current practice.

Conclusion

3.115 This chapter has reviewed, and made recommendations in relation to, the role of insolvency practitioners in the institutional framework for the administration of corporate insolvency laws. The following chapter considers the critical role of directors in corporate collapses, the duties owed to creditors in the period leading up

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82 *Submission* 22A, p. 5.

83 For a history of the current classes and registration requirements see the *Review of the Regulation of Corporate Insolvency Practitioners* (1997), Chapter 3.

to the company's financial difficulties and the obligations that arise during the course of the company's administration.

CHAPTER 4

THE DUTIES OF DIRECTORS

4.1 Insolvency laws and processes complement the general body of rules governing the duties of directors and provide a set of incentives and sanctions to guide the behaviour of directors during the life of the company. They serve to improve corporate governance and corporate ethics. Importantly they allow private creditors to replace the management of troubled firms and in this way create incentives for prudent corporate behaviour. They also permit an examination to be made of the circumstances giving rise to insolvency and the conduct of officers of the company in its collapse. Such examinations can reveal culpable behaviour on the part of those responsible for the company's failure or transfers of property that are potentially recoverable. They permit follow up action to be taken by the regulatory authority.

4.2 This chapter discusses the duties of directors when their company gets into financial difficulties. It looks at the assistance they are required to give to administrators and liquidators; their obligation to keep proper records, the position of administrators when their company becomes insolvent, voidable transactions, uncommercial transactions and the general fiduciary and statutory duties of directors in relation to creditors. The duty of directors toward employees is examined in chapter 9.

Director's obligation to assist the administrator or liquidator

4.3 One of the most important duties placed on a director of a company that has been placed in administration, receivership or liquidation is to assist those appointed to manage the affairs of the company.

4.4 The Corporations Act requires officers of corporations to give external administrators a report as to the affairs of a company (an RATA) within a specified time of the external administration commencing. 'Officer' as defined under the Act includes...'a director, secretary, executive officer or employee of the body or entity' and extends to a person who has been but is no longer an officer.[1]

4.5 Officers of corporations are also required to co-operate with the appointed receiver, administrator or liquidator by helping them to identify and realise company assets for the benefit of creditors. Officers and other people in possession of a corporation's books and records are also required, under the Act, to disclose the existence of such books and records or assets and deliver them up when requested by the appointed insolvency practitioner.

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1 The CLERP 9 Bill proposes to have one definition of 'officer' as contained in s 9 which generally covers persons who have a degree of influence or potential influence over the general conduct of the entity and inserts a definition of 'senior manager'.

4.6 In the case of a voluntary administration, directors and officers must prepare RATAs within 7 days of the appointment of an administrator.[2] Such a statement assists the administrator to assess the financial position of the company and to locate company assets at an early stage in the procedure. It also helps to avoid potential expense in otherwise ascertaining that information and to facilitate the process of reporting to creditors under s 439A. The requirements for RATAs are an important feature of the framework for facilitating external administrators' investigations and the discharge of their functions and in exposing abuses of the corporate form and breaches of corporate law.

4.7 The 1998 *Study of Voluntary Administrations in NSW* found that most administrators were not insisting on receiving a signed report as to affairs.[3] A number of submissions expressed concern about the requirement for directors to lodge reports. Mr Peter Lucas commented:

> The penalty provisions in relation to directors failing to lodge reports with Liquidators and Administrators should be tightened. Often the reports that are obtained are far from adequate. Both the Liquidators/Administrators and ASIC should have the power to reject a report if they believe it to be inadequate, and seek further information. Often directors discharge their obligations by simply writing down on a Report as to Affairs 'unknown' as to all the assets and liabilities, and, strictly speaking, they have fulfilled their duty. This is clearly an abuse of the system.[4]

4.8 QBE Trade Credit commented:

> …directors who do not specifically cooperate with insolvency practitioners or who fail to keep adequate books and records of a company or fail to provide a Report As To Affairs (RATA) should be barred from holding the position of company director, at least for a period of time. Furthermore ASIC needs to enforce compliance in this area and make it an offence to remain or become a director where that director has clearly failed to comply with their obligations and duties. This clearly doesn't prevent the initial insolvency but should avoid further corporate failures by that person and protect others, at least for a period of time.[5]

4.9 ASIC has indicated that it is prepared to prosecute company officers where they fail to provide a RATA when requested by a liquidator, administrator or receiver. The Committee notes that ASIC has issued strong warnings to directors and officers of failed companies about their obligations to hand over the company books and provide information about assets to companies' liquidators and has instituted a program of prosecutions in support of these requirements. As at May 2003, 303

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2 Section 438B(2).

3 1998 Australian Securities Commission commissioned research paper, *A Study of Voluntary Administrations in NSW,* p. 35.

4 *Submission* 33, p. 6.

5 *Submission* 49, p. 4.

company officers had been prosecuted nationally for 463 offences under the Corporations Act for failure to co-operate with liquidators, resulting in fines and costs of $350,272. ASIC obtained 69 civil orders in which the court ordered company officers to provide an RATA or hand over books and records.[6]

4.10 Practice Note 50 sets out a framework of assistance for the obtaining of RATAs and establishes procedures for external administrators to take in the event of non-cooperation.[7]

4.11 In the 2003 Federal Budget, ASIC received additional funding of $12.3 million over the next four years for its corporate insolvency initiative. It aims to target its surveillance, investigation and enforcement activities focusing on winding up actions in identified high-risk sectors and fraudulent phoenix company activity. In a speech to the IPAA Conference in Adelaide in May 2003, Commissioner Collier indicated that one of ASIC's insolvency priorities for 2003 was to take action on more reports from liquidators.

4.12 The Law Council maintained that the increased number of prosecutions against directors failing to provide section 429 reports and section 475 reports has resulted in a much higher level of cooperation from directors in filing these reports.[8]

4.13 The Committee notes the strengthened arrangements that are in place to ensure the timely lodgement of RATAs and external administrators' statutory reports. However, it considers that it is not just the fact of lodgement of RATAs and statutory reports that is in issue. The quality of RATAs and external administrators' statutory reports must also be considered. That the quality of reports is at issue is highlighted by comments of the Australian Taxation Office (ATO) on the information available in corporate insolvencies. The ATO expressed concern that when administrators are appointed, the company records are often incomplete:

> The cost of bringing the records up to date is often costly and may not be done if there are insufficient funds available to the administrator or liquidator. In the absence of accurate and up to date records, administrators and liquidators are prevented from providing creditors with a full and complete assessment of the company's financial position and potential for recovery of preferential payments. The lack of adequate records has additional consequences for the Tax Office if the company has failed to

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6 Address by Berna Collier, ASIC Commissioner to IPAA Conference, Adelaide, 28 May 2003.

7 PN 50.69, 50.72.

8 *Submission* 26, p. 16. Section 429—Officers to report to controller about corporation's affairs—requires the reporting officers of a corporation which has been served with a notice that a person is a controller of property of the corporation to make out and submit to the person a report about the affairs of the corporation. Section 475—Report as to company's affairs to be submitted to liquidator—requires the directors and secretary of the company to make out, verify by a statement in writing and submit to the liquidator a report as to the affairs of the company.

lodge returns and statements due prior to the appointment of the administrator or liquidator.[9]

4.14 The Committee believes that good record keeping is an essential feature of good corporate governance. It shares the ATO's concerns about poor financial records. Although the law already allows for directors to be held accountable for incomplete record keeping, this clearly is an area that calls for greater vigilance.

Recommendation 8

4.15 The Committee recommends that, in its enforcement programs for the lodgement of reports as to the affairs of a company (RATAs), ASIC take greater account of the quality of reports provided.

4.16 The ATO noted that administrators are required to report certain matters to ASIC but are not required to report whether a company may be unable to pay its unsecured creditors more than 50 cents in the dollar. It proposed that administrators be required to report to ASIC whether a company may be unable to pay its unsecured creditors more than 50 cents in the dollar similarly to liquidators.[10]

4.17 The Committee considers that it is inappropriate to impose a statutory requirement to indicate a level of return to creditors (such as whether the company will be able to pay unsecured creditors more than 50 cents in the dollar) at the relatively early stage in which a voluntary administration occurs. The voluntary administration procedure is not a complete insolvency procedure in itself and contemplates other possible insolvency proceedings and outcomes such as a liquidation in which the above requirement will obtain. An administrator may be able to provide an indication of the level of return to creditors at the second meeting of creditors.

Directors to be required to reconstruct accounts

4.18 The ATO proposed that administrators and liquidators should be required, where necessary, to reconstruct company accounts to a standard sufficient to facilitate the performance of their duties under the Act. It recommended that administrators and liquidators should be able to apply to the court for an order against each company director in respect of these costs.[11]

4.19 The Corporations Act currently imposes strict requirements on all companies to keep written financial records that correctly record and explain its transactions and financial position and performance.[12] Section 286 places an obligation on a company to keep written financial records that correctly record and explain its transactions and

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9 *Submission* 14, p. 4.

10 *Submission* 14, p. 4.

11 *Submission* 14; p. 4. and see paras. 4.10-11 above.

12 Section 286.

financial position and performance and would enable true and fair financial statements to be prepared and audited. A breach of this section is a strict liability offence carrying a penalty of 25 penalty units or imprisonment for 6 months or both.

Recommendation 9

4.20 The Committee is concerned about the allegations of poor record keeping and believes that the current penalty regime for breaches of section 286 may not be adequate. The Committee recommends that the Government review the penalties attached to breaches of section 286 with a view to making them more effective as a deterrent.

4.21 As noted earlier, the Corporations Act also requires officers of corporations to give external administrators a report as to the affairs of a company. Section 475 permits a liquidator to pay a person for the costs and expenses of preparing a report on the affairs of the company out of the company’s property.

4.22 The Committee notes the clear obligation on directors to keep financial records and, in the event of a company's failure, to provide a report on the company's affairs to the administrator. Failure to comply with these obligations is a clear breach of their duties. To the Committee, it seems only fair and reasonable that directors who do not keep proper records should be the ones held accountable for the costs incurred by an administrator in having to reconstruct financial records because of the directors' failure. The Committee considers that such costs should not be born by the creditors.

Recommendation 10

4.23 The Committee recommends that the Government consider amending the law to permit an administrator or a liquidator to recover from directors who have failed to ensure that company records are complete and up-to-date, the costs and expense of reconstructing the company's financial records in order to prepare a full and complete report on the affairs of the company. Directors would be held jointly and severally liable.

Insolvent trading and director's liabilities

4.24 A company director will be liable for insolvent trading where he or she was a director of a company at the time it incurred a debt, the company was insolvent at that time (or became insolvent because of the transaction), there were at the time reasonable grounds for suspecting that the company was (or would become) insolvent and the person was (or reasonably should have been) aware that there were reasonable grounds for suspecting insolvency. A holding company will be liable for the debts incurred by its insolvent subsidiaries where there are reasonable grounds for suspecting that the subsidiary company is or will become insolvent at the time of incurring the debt and the holding company, or one or more of its directors, were or should reasonably have been, aware of those grounds.

4.25 Defences to liability for insolvent trading are available to directors under the law, for example where there were reasonable grounds to expect solvency, where the

director had relied on a competent person or where the director had taken reasonable steps to prevent the company from incurring the debt. The insolvent trading provisions were the subject of examination in two recent notable instances.

4.26 The HIH Royal Commission commented on the application of the insolvent trading provisions to HIH Group transactions. It did not make an adverse finding that any person might have committed an offence under s 588G of the Corporations Act. Justice Owen's report noted the difficulty 'which any prosecution would face in establishing beyond reasonable doubt the insolvency of a general insurer with long-tail liabilities' and the further complication of the HIH group's organisation.[13]

4.27 It also noted the difficulty in establishing the ingredients of the offence in the circumstances including the identification of the corporate entity of the group that incurred the debt, the directors of the entity, whether the entity was insolvent and the state of knowledge of the directors.[14] Importantly, Justice Owen did not appear to be critical of the structure and content of the insolvent trading provision or the underlying policy intent. Rather he considered it was a question of a lack of evidence available to him and the peculiarities of the insurance industry and the circumstances of the HIH group.

4.28 On 30 June 2003, the Supreme Court of Victoria ordered that John Elliott, Bernard Plymin and William Harrison be prohibited from managing a corporation for periods of four, ten and seven years respectively; and that Elliott and Plymin each pay compensation to the Water Wheel companies of which they were directors in the amount of $1,428,000 for breach of the duty of a director to prevent insolvent trading by a company.[15]

4.29 Mr Elliott argued that the companies were not insolvent at the time the debts were incurred, or that even if the companies were insolvent, he did not have reasonable grounds for suspecting that the companies were insolvent. These arguments were rejected by the Court. The Court determined that the Water Wheel companies were insolvent by reason of the fact that they were unable to pay their debts as and when they fell due. It was not relevant that the value of the companies' assets exceeded the value of their liabilities.

4.30 The Water Wheel case underlines the harsh penalties that may be imposed upon company directors who breach the duty to prevent a company trading whilst insolvent, the necessity for company directors to make a determination about the solvent status of their company and take action to prevent a company continuing to incur debts if it is insolvent and the deterrent effect of the insolvent trading provisions.

4.31 ASIC indicated that Water Wheel was one of a number of cases in which it had taken successful enforcement action after investigations into failed companies. In

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13 HIH Royal Commission Report, vol. 3, p. 44.

14 HIH Royal Commission Report, vol. 3, pp. 61-2.

15 *ASIC v Plymin*, 46 ACSR 126.

the last two years, examples of enforcement results achieved by ASIC in relation to insolvent trading, and directors' duties offences involving an insolvency, included criminal prosecutions against Farmer Furniture Pty Ltd (defendant directors' sentences ranged from three to five years suspended with $20,000 good behaviour bonds for insolvent trading); Twintara Pty Ltd (defendant director sentenced to two years and nine months jail wholly suspended upon entry of a three year $2,000 good behaviour bond for insolvent trading); Fosmeats Pty Ltd (director sentenced to two and a half years jail for improper use of his position and falsification of books and records). Civil penalty proceedings were pursued in relation to Snowdeli Pty Ltd (banning and pecuniary penalty orders obtained); Rodney Adler and Ray Williams (banning and pecuniary penalty orders obtained); Allied Financial Pty Ltd, Wharton Partners Pty Ltd and others against dispersing monies in an alleged phoenix operation and officers of OneTel Limited (Rich, Keeling, Silbermann and Greaves) resulting in banning and pecuniary penalty orders.[16]

National Insolvent Trading Program

4.32 In January 2003, ASIC initiated a Directors Insolvent Trading pilot that aimed to ensure directors focus on the financial position of their companies and take appropriate financial advice. The pilot project was initiated in response to complaints from insolvency practitioners concerning the need to take early action against insolvent trading by companies. The National Insolvent Trading (NIT) Program emerged from the pilot project conducted in Sydney and Melbourne from January to June of 2003. The NIT Program adopts a targeted approach to dealing with possible insolvent trading before it occurs. It entails a review of a company for the purposes of ensuring compliance by directors with their duties under s 180 of the Corporations Act and their duties to prevent insolvent trading under s 588G.

4.33 The program, to be implemented over 2003-04, aims to make directors of potentially insolvent companies aware of their company's financial position, their own responsibilities and the implications of continued trading. It is also intended to encourage them to seek external advice on restructuring possibilities or advice from insolvency professionals and, if the circumstances warrant, to take action to appoint a voluntary administrator or liquidator.

4.34 Under the project, companies are identified as likely to be experiencing financial stress. They include small proprietary companies, large proprietary companies, unlisted public companies and listed entities. ASIC utilises a number of sources to identify companies for the program, such as complaints from the public, credit managers and company employees, the annual accounts of listed companies identified as financially-stressed, information from liquidators, and referrals from other areas within ASIC.

4.35 In a Media Release, ASIC described the object of the Program:

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16 *Submission* 24, pp. 10-11.

> A key aim of the program is to have directors focus on the solvency of their companies and to take action sooner, rather than later, where solvency problems exist. All too often there is a culture of denial of financial difficulties. Early action maximises the chances of the company surviving, which in turn minimises the hardship to creditors and costs to the Australian economy caused by insolvent trading.[17]

4.36 ASIC recorded that in the six months since the program was established (to 31 December 2003):

- surveillance visits of 285 companies (including a number of related companies) were conducted;
- 26 companies appointed a voluntary administrator or liquidator following a visit;
- updated or additional financial information was sought from 105 of the companies visited; and restructuring advice was sought by directors of a significant number of companies visited.[18]

4.37 The Committee considers that tailored, preventative strategies such as the NIT Program represent innovative and proactive solutions to deterring insolvent trading and phoenix company activities. It supports such preventative strategies held on an appropriately recurrent basis as an important addition to ASIC's surveillance, investigation and enforcement activities, particularly in relation to unlawful phoenix companies.

4.38 While the Committee has limited empirical data available to it on the impact of the insolvent trading provisions from which it may draw firmer conclusions, it considers that the provisions provide an important deterrence to insolvent trading.[19] Preventative programs such as the NIT Program usefully reinforce civil and criminal proceedings initiated by ASIC. The Committee notes in a recent assessment of the necessity for corporate law reform that Professor Baxt endorsed the insolvent trading provisions:

> I start this overview by making one very clear and strong statement. The law relating to insolvent trading (and related matters) now operating in Australia

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17 Media release, Court decision a first for ASIC's Insolvent Trading Program, 3 February 2004.

18 Media release, 3 February 2004.

19 In June 2004 Clayton Utz and the Centre for Corporate Law and Securities Regulation of the University of Melbourne published an Empirical Study of insolvent trading cases based on court judgments. The Study provides a valuable insight into the operation and impact of the insolvent trading provisions. This report was substantially completed prior to the publication of the study. A copy of the Empirical Study may be found at http://www.claytonutz.com/ and http://cclsr.law.unimelb.edu.au.

> is more than adequate, in general terms, to deal with the issues that have arisen recently.[20]

Definition of Insolvency

4.39 Section 95A defines 'insolvency' generally for the purposes of the Corporations Act. Under s 95A, a company is insolvent if the company is not able to pay all the company's debts as and when they become due and payable. The statutory definition of insolvency suggests that a cash flow test rather than a balance sheet test is to be applied in determining insolvency although courts will usually consider both tests and the overall situation of the company.

4.40 Mr Leon Zwier criticised the definition of insolvency in s 95A on the ground that it fails to provide clear guidance as to insolvency, leaving the ambit of the words to be clarified by the courts on a case by case basis. A number of presumptions of insolvency assist in establishing that a company is insolvent for the purposes of the insolvent trading and voidable transactions provisions (such as s 588E: a failure to keep accounting records) or in support of an application for a winding up order on the ground of insolvency or on other grounds (such as s 459C(2): failing to comply with a statutory demand).

4.41 The Committee considers that a determination of insolvency requires an evaluation of the particular facts and circumstances and that a case law approach takes account of the diversity of possible circumstances of insolvency and the particular facts of each case and has the flexibility to evolve over time. A prescriptive approach to the definition of 'insolvency' may focus undue attention on the literal meaning rather that its substance. It considers that there are advantages in continuing with an approach based on case law but accepts that the process of seeking court decisions is time consuming and costly and the applicability of decisions limited. There is scope to clarify the meaning of 'insolvency' in ASIC Practice Note 22 which provides guidance to directors as to what they should take into account.

4.42 The Committee notes that a company's directors must pass a solvency resolution within 2 months of the company's annual review date (usually the anniversary of the company's registration), unless the company has lodged a financial report with ASIC within the previous 12 months.[21] Where the company has lodged a financial report with ASIC within the previous 12 months the financial report must include a director's declaration that (among other things) there are reasonable grounds to believe the company will be able to pay its debts as and when they become due and payable.[22]

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20 CCH Australia Ltd, *Collapse Incorporated, Tales Safeguards & Responsibilities of Corporate Australia*, 2001, Ch 11, p. 329.

21 Section 347A.

22 Section 295(4)(c).

4.43 There are two types of solvency resolutions: a positive solvency resolution that is passed when the directors have reason to believe that the company will be able to pay its debts as and when they become due and payable and a negative solvency resolution that is passed when the directors have reason to believe that the company will not be able to pay its debts as and when they become due and payable.

4.44 The Committee considers that the requirements for a solvency resolution or a director's declaration as to a company's ability to pay its debts permits the issuing of a comprehensive standard industry practice note as to what constitutes insolvency for the benefit of the corporate sector. A practice note might comprehensively review the case law on the meaning of insolvency and include other accepted indicators of insolvency and steps that companies may take to minimise the risk of insolvency. Practice Note 22 currently provides limited guidance to directors and auditors concerning the directors' statement as to insolvency.

Recommendation 11

4.45 The Committee recommends that ASIC issue a practice note as to what constitutes insolvency for the guidance of company directors passing solvency resolutions and making director's declarations.

Administrators' reporting of insolvent trading

4.46 An administrator must provide creditors with a report to guide them in their decision-making at the second meeting of creditors. His or her statement must include an opinion as to whether there are any transactions that appear to be voidable transactions in respect of which money, property or other benefits may be recoverable.[23] The Australian Bankers' Association (ABA) expressed concern that there are limited incentives for administrators to investigate breaches of the law, particularly in respect of insolvent trading and antecedent transactions of the company. There is even less incentive for the administrator to actively investigate such matters where the creditors may be prepared to accept a deed of company arrangement. It commented:

> ABA acknowledges that cost is a key factor in a voluntary administration but creditors should know when considering a deed of company arrangement whether there is evidence that the directors have continued to operate the company whilst it is insolvent or have committed other breaches of the law. At present the administrator need only form an opinion for creditors about voidable transactions (regulation 5.3A.02) and not whether there has been insolvent trading.[24]

4.47 Crutchfield's *Corporate Voluntary Administration* also comments on the limitation of reg. 5.3A.02 noted by the ABA:

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23 Regulation. 5.3A.02.

24 *Submission* 28A, p. 11.

> …the use of the phrase 'voidable transactions' in reg. 5.3A.02 means that this requirement arguably does not cover other rights of recovery open to a liquidator, such as rights against the company's directors for insolvent trading. However, these may nevertheless be relevant to the creditors' decision and should be included.[25]

4.48 The Committee acknowledges that an administrator is subject to time constraints in investigating and commenting on possible voidable transactions or insolvent trading. In chapter 6, however, it recommends that the time limits for the conduct of the first and second meetings of creditors be extended. Given the extended timeframe, it agrees that reg. 5.3A.02 should cover other rights of recovery open to a liquidator, in particular rights against the company's directors for insolvent trading.

Recommendation 12

4.49 The Committee recommends that reg. 5.3A.02—administrator to specify voidable transactions in statement—be amended to include rights of recovery against the company's directors for insolvent trading.

Director liability in relation to voidable transactions

4.50 Insolvency law has long adopted a policy of setting aside transactions in which an insolvent company disposes of property or makes payments to particular creditors within a relevant period of time prior to the commencement of formal insolvency. The voidable transactions provisions of the law aim to prevent the depletion of the assets of the company through certain transactions entered into within a specified period prior to the winding up.

4.51 Some submissions commented on features of the voidable transaction provisions. One proposed that 'insolvency' should not be a prerequisite for a finding that a transaction is an 'uncommercial transaction'.[26]

Uncommercial transactions

4.52 The principle of fairness in a liquidation demands that the law protect the general body of creditors from dispositions of a company's property which confer improper advantages on particular creditors. Under the Corporations Act liquidators may recover payments made, or reverse transactions entered into, by companies in the period preceding the company's liquidation. Division 2 of Part 5.7B deals with those

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25 Crutchfield's Corporate Voluntary Administration, p. 11. Regulation 5.3A.02 reads: The administrator of a company under administration, in setting out his or her opinions in a statement mentioned in paragraph 439A (4) (b) of the Act, must specify whether there are any transactions that appear to the administrator to be voidable transactions in respect of which money, property or other benefits may be recoverable by a liquidator under Part 5.7B of the Act.

26 *Submission* 6, p. 10.

company transactions and payments which may be challenged by a liquidator during the two-year period preceding formal insolvency.

4.53 One type of transaction that may be challenged under the avoidance provisions is an uncommercial transaction. A transaction of a company may be declared to be an uncommercial transaction if, having regard to a number of matters, '…it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction '. They include whether any benefit or advantage was obtained by the company from the transaction or whether the transaction caused some detriment to the company that cannot be explained by normal commercial practice.[27] An uncommercial transaction is voidable only if it is entered into or given effect to when the company is insolvent or if it contributes to the company becoming insolvent.

4.54 A number of submissions suggested that insolvency should not be a prerequisite for the avoidance of an uncommercial transaction. Mr Sellars, Manager, Governance and Insolvency Unit, Department of the Treasury, on the other hand stated that there would be a prospect of injustice to some parties if the requirement for insolvency is removed. Also, in his view, if you take the element of insolvency out of 'uncommercial transaction', it becomes a very broad provision. He said:

> one of the key issues—or one of the key policy drivers—has always been that companies should be free to deal with its property until the point is reached where the company could do damage to its creditors by taking those steps.[28]

4.55 The Committee was concerned with the narrow application that may arise from this interpretation and looked to the Bankruptcy Act for guidance.

4.56 Mr Kerr said that the requirement of insolvency for the operation of this provision should be contrasted with the equivalent provision in the *Bankruptcy Act 1966* and its predecessor, which was incorporated into company insolvency law. Neither the present s 120, dealing with undervalued transactions, nor its predecessor dealing with voidable settlements, required the trustee or the liquidator to demonstrate that the company or the debtor was insolvent at the time it disposed of its assets at less than their fair value.[29]

4.57 Professor Keay also spoke in support of the view that insolvency should not be a prerequisite for the avoidance of an uncommercial transaction. He said:

> It was proposed by one submission you received that it should not be necessary for a liquidator to establish that the company was insolvent at the time that an uncommercial transaction was given prior to the liquidation. I

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27 Section 588FE(3).

28 *Committee Hansard*, 26 June 2003, p. 32.

29 *Submission* 6, p. 9. and *Submission* 23A, p. 7.

> have long held this view…It has always seemed to me to be rather anomalous.
>
> The section that deals with uncommercial transactions is 588FB. It effectively replaced section 120 of the Bankruptcy Act when the 1992 act came into being. Section 120 of the Bankruptcy Act did not require the trustee in bankruptcy or the liquidator to establish insolvency. The present section 120 of the Bankruptcy Act, which was amended in 1996-97, does not require insolvency. So it is a little difficult to see why it was introduced. …But with uncommercial transactions what one is dealing with is what I term 'debtor misbehaviour' where the debtor company—the directors, usually—is trying to get property to an associate or a relative at less than market value. It seems to me that the issue of insolvency really should not come into it because these types of transactions should be thwarted. They are serious breaches of the whole corporate set-up.[30]

4.58 An uncommercial transaction is distinguishable from an unfair preference. Professor Keay noted:

> Unlike unfair preferences, where the idea is to stop creditors from jumping to the head of the queue and from stopping the company 'robbing Peter to pay Paul', the idea behind the uncommercial transaction and its ilk is to arrest the debtor misbehaviour and prevent the disposition of the company's assets.[31]

4.59 The Committee considers that the requirement to establish insolvency can impede the recovery of property of the company for the benefit of creditors. It imposes an unnecessary restraint on the provision. It notes that under new section 588FE(6A), an unreasonable director-related transaction is voidable irrespective of whether the company was insolvent at the time the payment, transfer or disposition of property occurs or at the time the company incurred the obligation.

Recommendation 13

4.60 The Committee recommends that insolvency be removed as a prerequisite for the avoidance of uncommercial transactions which may be challenged by a liquidator. Such transactions are to have taken place during the two year period preceding formal insolvency.

Expand presumptions of insolvency

4.61 Ordinarily a liquidator must prove insolvency when he/she seeks to recover a payment made to a preferred creditor by a company that shortly afterwards goes into liquidation. Statutory presumptions apply to the insolvent trading and voidable

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30 *Committee Hansard* 14 August 2003, p. 211 and see Keay, Andrew, *Liquidators' Avoidance of Uncommercial Transactions*, (1996) 70 ALJ 390.

31 Keay, Andrew, *Liquidators' Avoidance of Uncommercial Transactions*, (1996) 70 ALJ 390, 400.

transaction provisions and operate to assist a liquidator in establishing the insolvency of a company at a particular time.

4.62 A presumption of insolvency avoids the evidentiary difficulty which confronts a liquidator where the company has inadequate records or no records at all. Section 588E creates a presumption of insolvency where a company fails to keep or retain financial records in contravention of s 286. Under s 588E(7) this presumption does not apply to an unfair preference claim.

4.63 A number of submissions proposed that the presumptions of insolvency be expanded. Mr Kerr commented:

> Establishing when a company became insolvent is one of the most difficult tasks that confronts an insolvency practitioner. The task is made more difficult when the company's financial records are incomplete or poorly maintained. A rebuttable presumption of insolvency was introduced into the Law in the CLRA. If a company fails to maintain adequate accounting records the company is deemed to have been insolvent for the period to which the inadequacy relates. However, the presumption is not available in actions against third parties. Poorly maintained or inadequate books and records remain a problem experienced in many company windings up. Consideration should be given to expanding the available rebuttable presumptions of insolvency available to company liquidators in order to reduce the cost and difficultly in recovering assets for the benefit of creditors as a whole.[32]

4.64 Mr Lucas also noted that there are difficulties in establishing that a company is insolvent. He proposed that more presumptive tests and the switching of the onus of proof to directors would assist. He suggested that a company that has failed to remit its GST or PAYG tax in two successive periods, or failed to meet superannuation payments in two successive quarters should be presumed to be insolvent. The onus then should be on the directors to establish that they were able to pay those debts but chose not to.[33] The Committee considers that to establish a presumption of insolvency for the purpose of other proceedings poses difficulties in that it may conflict with the secrecy provisions of taxation legislation. For this reason the Committee is reluctant to support an amendment along these lines.

4.65 Submissions also suggested that a proposal made by the Harmer Report, but not adopted in the *Corporate Law Reform Act 1992*, should now be reconsidered.[34] The Harmer Report recommended that there should be a presumption that a company being wound up in insolvency was insolvent 90 days immediately before the commencement of the winding up. Evidence about the usual financial condition of most insolvent debtors pointed overwhelmingly to a state of insolvency existing for

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32 *Submission* 6, p. 10.

33 *Submission* 33, p. 6.

34 *Submission* 6, p. 7.

some time prior to the commencement of formal insolvency.[35] The Harmer Report acknowledged that the period of 90 days was necessarily arbitrary but considered that in most cases it comes close to reality and is not commercially unfair. A presumption of insolvency during the short period of 90 days would assist insolvency practitioners in recovering voidable transactions and provide creditors with information as to possible recoveries from voidable transactions in a liquidation when considering the merits of entering into a deed of company arrangement.

4.66 Professor Keay proposed a similar mechanism. He argued that in one respect the voidable transaction provisions did not meet the rationale for the avoidance of preferences, the equal treatment of creditors and deterring the dismemberment of companies. Section 588FG exacerbates the problem. It basically permits a person who received a preference to keep the proceeds if he/she received it in good faith and was unaware of the company's insolvency. It has the effect of encouraging preferences because the recipient of a preference incurs no sanction in accepting it. At the very worst he/she will have to repay the preference to a liquidator. But he/she will have had the use of the monies in the meantime. And there is also the possibility that a liquidator might not discover the preference or not have the funds to pursue its recovery. The recipient may then keep the preference.

4.67 Professor Keay proposed that a liquidator be able to avoid any preference transaction that takes place within a set period before winding up—60 or 90 days—such that he/she would only have to prove that the transaction falls within the period, it related to a past debt of the company and the effect of it was to give the recipient an advantage over other creditors.[36]

4.68 The Committee considers that these arguments are highly persuasive. The case for a presumption of insolvency in a limited period of time prior to the commencement of insolvency, forcefully made in the Harmer Report, is still strong.

4.69 Logie-Smith Lanyon raised concerns about the application of the voidable transactions provisions where there are not two parties to a transaction (ie company and creditor) but three.[37] In its view the application of the voidable transaction provisions are uncertain in the circumstance where a company owes money to A but a related party pays A and the relationship between the related party and the company is not that of creditor and debtor.

4.70 The Committee acknowledges the concerns of insolvency practitioners about the usefulness of the voidable transaction provisions. It understands that extensions of the presumptions of insolvency to third parties having no knowledge of or control over the company's financial records may be unjust in some circumstances. Although it considers that the scope of the voidable transactions provisions is a matter of

35 ALRC Report No 45, vol. 1, para. 639.

36 *Committee Hansard*, 14 August 2003, p. 214.

37 *Submission* 20, p. 5.

interpretation for the courts, it draws these issues to the attention of the Treasury for closer consideration.

General duties of directors

4.71 Many submissions to the Committee expressed concerns that the corporate form was open to abuse by directors to disadvantage creditors and employees. The Corporations Act adopts a variety of mechanisms to deter abuse of creditors and assist in the restoration of funds, assets and other property to companies for the benefit of creditors. The insolvent trading and voidable transactions provisions of the law are key elements of the architecture of the law for the protection of creditors and shareholders and the deterrence of corporate abuse.

4.72 The general fiduciary and statutory duties of directors are traditionally expressed to be owed to the corporation as a whole. In practice this means among other things that the directors must give primary consideration to the interests of existing members of the corporation as they are the proprietors who have risked their capital in the expectation of a return. In recent decades the courts have expanded traditional statements of directors' duties to support the view that directors have a duty to consider the interests of creditors in certain circumstances. Section 1324 of the Corporations Act (which confers a statutory right on shareholders and other persons who can establish that they have an interest in pursuing a claim to enforce the statutory duties of directors) also lends support to the proposition that directors not only owe a common law duty but also a statutory duty to creditors in certain circumstances.

4.73 The question arises whether the general fiduciary and statutory duties of directors as expressed in the law give sufficient recognition to the protection of creditors. Fraud and mismanagement directly affecting unsecured creditors may arise in circumstances of financial stress and in anticipation of insolvency. The following section looks at directors' duties to take account of the interests of creditors.

Duty to creditors

4.74 Some submissions proposed that the Corporations Act should specifically provide for a duty to take account of the interests of creditors. Mr Lucas commented:

> I believe the Corporations Act deals fairly well with the duties of directors in respect of their obligations. The one addition I would make is to clearly outline in the legislation that directors have an obligation once they become concerned as to the company's financial position to consider the interests of creditors.[38]

4.75 The ACTU stated:

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38 *Submission* 33, p. 6.

> …there are grounds to re-examine the law's treatment of unsecured creditors generally in these cases, and to give consideration to changes to their rights and to the beneficiaries of directors' duties on a broader basis, including to place directors' responsibilities to employees, customers, suppliers and the community on an equal basis to their obligations to shareholders.[39]

4.76 The Final Report of the UK Company Law Review Steering Group in June 2001 recommended the inclusion of a statement of duty of directors towards creditors in the case of insolvency essentially in terms of the UK insolvent trading prohibition. This statement was largely based on existing insolvency law and did not add to the law as it currently existed. The Government's White Paper, *Modernising Company Law*, rejected the Steering Group recommendation on the ground that it conflated company law and insolvency law.[40]

4.77 The Steering Group also raised the possibility of introducing a duty to act in the interests of creditors along with shareholders where insolvency was not necessarily imminent but was a possibility. This proposal was also rejected on the ground that any decision about the point at which insolvency was a possibility rather than imminent would necessarily be an extremely finely balanced decision.

4.78 The Committee does not recommend the inclusion of a statement of the duty owed to creditors in the statutory codification of the general duties of directors in Part 2D.1. Duties owed to creditors are integral to insolvency law not company law and are better located there. The Committee considers that the courts are best placed to consider and further develop the law on directors' duties in its application to shareholders, creditors and employees.

4.79 Remedies are available to creditors in relation to breaches of the general duties of directors and for contraventions of the insolvent trading provisions of the Corporations Act. As noted above the voidable transaction provisions permit recovery from directors. Two recent initiatives, in particular, need time to be tested.

4.80 First, the *Corporations Law Amendment (Employee Entitlements) Act 2000*, which introduced new Part 5.8A, has the aim of protecting employee entitlements from agreements and transactions that are entered into with the intention of defeating the recovery of entitlements or significantly reducing the amount of entitlements to be recovered. It also aims to deter the misuse of company structures and other schemes to avoid the payment of amounts to employees that they would be entitled to in a liquidation. Contravention of the provisions renders directors liable to civil and criminal penalties and the payment of civil or criminal compensation to persons who

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39 *Submission* 32, p. 6.

40 The Final Report is available at www.dti.gov.uk/cld/final_report/ See Chapter 3, paras. 3.12-20. The White Paper, Modernising Company Law, Command Paper CM 5553, is available at www.dti.gov.uk/companiesbill/whitepaper.htm See p. 28.

have suffered loss as a result of the company incurring the unsecured debt or conferring the financial benefit.

4.81 Second, the *Corporations Amendment (Repayment of Directors' Bonuses) Act 2003* amended the voidable transactions provisions to permit liquidators to reclaim unreasonable director-related payments and transfers of property made to directors by their companies up to 4 years prior to liquidation.

4.82 The Committee believes that the content of our corporate laws must achieve an appropriate balance between the encouragement of entrepreneurial endeavour and trust in the office of director. Entrepreneurship is of immense value to a country. It generates wealth, secures market access and opens up opportunities for a community. Entrepreneurship necessarily entails risk-taking. Not all entrepreneurial undertakings will be successful. Nor is business failure an aberration.

4.83 A recent Productivity Commission study of business failures in Australia has underscored the fact that business exits are a natural and expected phenomenon associated with dynamic market economies.[41] The study noted that although business exits—particularly failures—often involve negative outcomes, they have positive economic effects. Productivity growth is enhanced when inefficient and unprofitable businesses are replaced by efficient and profitable ones. Exits may be the result of longer-term structural changes that provide an opportunity for resources in the economy to be configured in new and better ways. The learning experience gained by entrepreneurs involved in exits will assist them in doing things differently next time around.

4.84 These findings have implications for the design of insolvency law. The limited liability company has been the most successful vehicle for the expression of entrepreneurial endeavour yet devised. As Justice Kirby has noted, 'the idea of an independent corporation, governed by directors and accountable to shareholders, was a brilliant one. It permitted people to raise capital from the public to invest it without, in most cases, a danger of personal risk and to engage in entrepreneurial activity which, otherwise, would probably not occur.'[42] A danger in launching a new set of rules for directors or expanding further the scope for director liability is that the law may deter persons from accepting company directorships and crush the spirit of entrepreneurship. The Committee, however, does not resile from the proposition that, where shareholders' funds are entrusted to entrepreneurs they must ensure that shareholders and creditors (including employees) are appropriately protected in the context of the enterprise's collapse.

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41 Business Failure and Change: An Australian Perspective, Staff Research Paper, Productivity Commission, Ian Bickerdyke, Ralph Lattimore, Alan Madge, December, 2000, p 3. The Study is available at http://www.pc.gov.au. See also OECD, Science, Technology and Industry Outlook, 1998, Paris, p. 112.

42 The Hon Justice Michael Kirby, *The Company Director: Past, Present and Future*, The Australian Institute of Company Directors, Tasmanian Division, luncheon address, Hobart, Tasmania, 31 March 1998.

4.85 The Committee notes the introduction of recent legislation designed to assist recovery actions by liquidators for the benefit of creditors. It has also made recommendations in this chapter that will further assist liquidators in their duties. They are intended:

- to promote a greater awareness among directors of their obligations to ensure that the company maintains proper financial records;
- to make directors more accountable for failing to keep proper records; and
- to increase the scope for the recovery of debts created through uncommercial transactions.

4.86 It should be noted that the duties of directors in relation to employee entitlements is examined in depth in chapter 10. This chapter has focused on the role of directors in the circumstances preceding a company's insolvency, and the duties and obligations of directors arising when the company enters formal insolvency. The following chapter appraises the most widely used insolvency procedure—corporate voluntary administration.

CHAPTER 5

VOLUNTARY ADMINISTRATION—SUCCESS OR FAILURE

5.1 The primary stated object of the voluntary administration (VA) procedure is to maximise the chance of the company emerging from administration with as much as possible of its business continuing in existence. Where the survival of the company or its business is not possible, the secondary object is to provide for a fair and efficient winding up and in particular one that results in a better return for the company's creditors and members than would result from an immediate winding up of the company. The legislation is flexible in that section 435A merely states the objects of the part and not the criteria against which an administration must be assessed.

5.2 This Chapter reviews appraisals of the VA procedure emerging from submissions and the testimony of witnesses. It attempts to reach some conclusions on the basis of the evidence presented to it as to whether the VA procedure, after a decade of operation, is achieving the objectives set for it. That is whether it represents a useful and valuable procedure for companies that may be facing insolvency or financial difficulty and their creditors.

5.3 While many submissions were critical of particular features of the VA procedure and suggested alternative approaches in a number of areas, overall submissions commented positively on the procedure. The general view expressed in submissions was that the VA process is a useful and valuable procedure for companies that may be facing collapse.

Support for the voluntary administration procedure

5.4 Mr Ron Harmer commenting, after ten years of its operation, on the scheme of which he was the prime architect said:

> On an international or comparative level there is little doubt that in terms of the important fundamentals the Australian model meets every fundamental requirement. I think its greatest strengths are that it is an efficient and relatively easy procedure to invoke. Cost wise, I think it compares more than favourably with similar regimes in other countries. It has the great benefit of flexibility and, above all, it does truly enable the possibility of the rehabilitation or rescue of a corporation that is in financial difficulty. Whether that is actually occurring in practice is something that, as I said earlier, I do not think I am competent to talk on, but when I look at the type of statistics that are available, it becomes apparent that it must be working in a fairly favourable way.[1]

1 *Committee Hansard*, 17 September 2003, p. 272.

5.5 Many insolvency practitioners also supported the procedure. Mr Leon Zwier said:

> The primary submission I would make is that Part 5.3A generally, in my view, works satisfactorily for the purposes of reorganising companies' affairs. Probably the most recent example I could take you to, in which I have been involved, would be the Ansett administration, where I acted on behalf of the voluntary administrators, the 'two Marks'. In that particular administration, with a very strong supervisory role of the court, it worked very successfully.[2]

5.6 Mr Philip Crutchfield, barrister and author of a leading textbook on the VA procedure, added:

> I would agree with Leon that generally the system works, and one indicia of that is the fact that the UK have in large part copied our provisions now in their Enterprise Act.[3]

5.7 CPA Australia observed that the voluntary administration 'system has now been a way of corporate life in Australia for almost ten years and, by and large, has served industry and commerce reasonably well'.[4] Jones Condon suggested some changes to the VA procedure but added:

> We have mainly focused on the appointment and removal of an Administrator because of our concerns that there is a movement for change to a system which we believe has worked exceptionally well since its inception in 1992 and which we also believe complies with the intentions of its author, Ron Harmer.[5]

5.8 The ABA commented that 'the current system of voluntary administration works well'.[6] The Law Council supported its continued use:

> The [Insolvency and Reconstruction] Committee is of the general view that creditor's rights are sufficiently protected in all forms of insolvency administration under the provisions of the Act.[7]

5.9 There is undoubtedly considerable support for the procedure if statistics are an indication of its success. The VA procedure is now the most commonly used form of external administration in Australia. The following ASIC statistical data on usage of the main forms of external administrations points to continued usage of the voluntary administration procedure.

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2 *Committee Hansard*, 7 August 2003, p. 122.

3 *Committee Hansard*, 7 August 2003, p. 124.

4 *Submission* 23, p. 3.

5 *Submission* 12, p. 1.

6 *Submission* 28, p. 3.

7 *Submission* 26, p. 12.

Companies entering External Administration: 1999-2003

Type	1999	%	2000	%	2001	%	2002	%	2003	%
Provisional wind-up	99		125		116		78		37	
Court wind-up	1,448	35	1,597	32.5	2,174	32.8	2,177	35	2,235	33.5
Creditors wind-up	633	14.7	915	18.5	949	14.3	1,049	16.9	1,268	19
Receiver appointed	43		48		74		42		48	
Controller (except receiver or managing controller)	127		156		203		112		85	
Managing controller (except receiver & manager)	3		6		10		3		0	
Receiver manager appointed	296	0.07	351	0.07	507	0.07	424	0.07	285	0.04
Scheme administrator appointed	2		2		1		0		4	
Administrators of company under administration	1,662	38.5	1,722	35	2,599	39	2,319	37.4	2,699	40.5
Foreign/RAB	1		0		1		4		0	
Total	4,314		4,922		6,634		6,208		6,661	

5.10 A 1998 research paper commissioned by the Australian Securities Commission, *A Study of Voluntary Administrations in NSW*, surveyed the use of the VA procedure from 1993-94 (the first full year of operation of the procedure) to 1996–97.[8] The paper pointed to the emergence of a clear pattern—the wide support for the VA procedure from its introduction. It showed that the up-take of the procedure has come at the expense of all other forms of external administration, particularly court-ordered administrations. The number of court appointed liquidations fell from 4,508 in 1991-92 to 2,035 in 1996-97. In the same period, appointment of administrators grew from 827 in 1993-94 to 1,937 in 1996-97.[9]

8 A copy of the paper is included as an attachment to submission 24.

9 1998 study, Appendix II, Table 3.

5.11 A decline in the number of appointments of receiver managers over the decade of the VA scheme's operation is also discernible. Over the four years from 1993-94 to 1996-97, the number of receiver managers appointed reached 2,381.[10] Over the four calendar years from 2000 to 2003 there were 1,550 receiver manager procedures initiated.

5.12 The 1998 ASC study indicated that some 5,760 companies entered into voluntary administration during the first four years of its operation. Of those:

592 or 10%	have resumed normal trading
994 or 17%	have been deregistered

Of those under administration:

458	had an administrator appointed
1,165	were subject to a deed of company arrangement
2,557	had a liquidator appointed

The study noted that the number of companies that would eventually be deregistered could possibly reach 75% (or higher) as the administration of deeds works to their conclusion.[11]

5.13 The Harmer Report envisaged that the procedure would be a success even if only a small proportion of companies were rescued.[12] Mr Harmer commented:

> …any regime that is designed to encourage rescue or rehabilitation will, of necessity, have a number—indeed, probably a fairly high percentage—of failures. I can recall during my work at the commission we thought, 'Maybe if you can save just 10 per cent of all insolvent or near insolvent corporations then you are going to be at least nine per cent in front'—in front of what was then happening. It is inevitable that you are going to get not so much abuse of the system, but you are going to get directors and companies invoking something like voluntary administration, perhaps with some faint hope or expectancy that there might be something to be rescued or retrieved.[13]

5.14 The most recent data since its inception confirms initial experience that the procedure is perceived as affording a viable means for addressing the circumstances of

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10 1998 study, Appendix II, Table 3.

11 1998 study, Appendix II, p. 19.

12 ALRC Report No 45, para 53.

13 *Committee Hansard*, 17 September 2003, p. 273.

companies in difficulty given the availability of other options. In 2003, 2,508 voluntary administrations were commenced representing 40.5% of total external administrations.

5.15 The statistical data for the operation of the procedure from 1999 to 2003 also highlight the impact of the VA procedure on schemes of arrangement in Part 5.1. The VA procedure was intended to replace the procedure of official management in the former Part 5.3 and not schemes of arrangement in Part 5.1. In 2003 there were only 4 schemes of arrangement initiated compared to 2,508 voluntary administrations. Over the five year period from 1999 to 2003 out of a total number of 28,253 external administrations 10,810 (or 38.26%) were voluntary administrations. Only eight comprised schemes of arrangement.

5.16 Witnesses to the Committee and the statistics are consistent with reviews of the operation of the VA procedure completed in 1998 which endorsed the procedure. The Advisory Committee said:

> The corporate voluntary administration procedure has been very successful. It is now the most commonly used form of insolvency administration in Australia.[14]

5.17 The ASC study expressed the following view:

> The study indicates that the VA process does provide a worthwhile system to give a company facing insolvency an opportunity to restructure its affairs and save its business. The procedures have generally worked for the benefit of the parties concerned and the findings of the study do not suggest that Part 5.3A requires wholesale changes or should be abandoned.[15]

5.18 Much of the data available in relation to the VA procedure relates to usage of the procedure. Such data does not necessarily provide a basis for evaluating the costs or benefits of the procedure and assessing whether creditors achieve a better outcome as a result of using the procedure than they would under the alternatives. Such evaluations and assessments are more difficult to make. The continued high use of the VA procedure while not necessarily a vindication of it as sound insolvency policy is a fair indication of its acceptance as an effective procedure.

5.19 Indeed, Anderson and Morrison observed that some inferences may be drawn from the fact that there is considerable support for the procedure:

> One might suggest that in a situation where sophisticated lenders such as banks support the operation of a system by its use, there is a strong reason for postulating that it must be seen as beneficial or at least beneficial to them as creditors. It might be expected in a situation such as this that the absence

14 *Report of the Advisory Committee on Corporate Voluntary Administration,* June 1998, p. 2.

15 ASC Research Paper 98/01: A Study of Voluntary Administrations in New South Wales, Australian Securities Commission, Sydney, 1998, p. 8.

> of widespread use of alternatives (eg restructuring outside of Part 5.3A and the reduction in court ordered liquidations) suggests that the procedure has considerable advantages. It is also possible that the law may be such that one particular group (eg directors) have been given such power that they can exclude the interests of other relevant parties. However this seems unlikely since sophisticated creditors who can afford good professional advice are unlikely to agree to participate.[16]

5.20 The scheme, however, is not without criticism. A number of submissions commented adversely on aspects of the process of appointing administrators and the ability of directors to manipulate the procedure for their own advantage.[17] The Committee considered the question of appointment of administrators by directors in chapter 3 and, while acknowledging some problems, reached the conclusion that the advantages of this means of commencing the VA procedure outweigh the risks.

Criticism of the voluntary administration procedure

5.21 The ATO was critical of the VA procedure. It stated that it supported the voluntary administration process but indicated that it was open to abuse in a number of respects. Its concerns included:

- too many non-viable deeds of company arrangement are being accepted;
- deeds of company arrangement are increasingly used as a means for avoiding paying some unsecured creditors ('there are very few Deed of Company Arrangements that yield reasonable dividends to creditors');[18]
- inadequate reconstruction of company accounts by administrators to a standard sufficient to facilitate the performance of their duties under the Act;
- the quality of reporting by voluntary administrators to creditors;
- an absence of impartiality on the part of some voluntary administrators;
- the use of phoenix companies.[19]

5.22 The concerns expressed by the ATO reflect the range of concerns of unsecured creditors about insolvency procedures generally and in the Committee's view are not indicative of a failure in the VA procedure. The Committee examined the Deed of Company arrangement provisions in chapter 11, the problems with reporting

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16 *Submission* 34, p. 10.

17 *Submission* 6, p. 5; *Submission* 14 and see Discussion Paper Independence of Company Administrators, IPAA Working Party on Administration, March 2001 at http://www.ipaa.com.au/pdfs/independance_company.pdf.

18 *Submission* 14, p. 7.

19 *Submission* 14.

obligations in chapter 4, the perceived lack of independence of administrators in chapter 3 and phoenix companies in chapter 8.

5.23 Several submissions suggested that the VA procedure is open to misuse in that it (rather than the CVL procedure) is being used as a means for placing a company into liquidation rather than as a means of enabling a company to continue in existence.

5.24 The ABA considered that directors were taking advantage of the VA procedure :

> In the absence of liquidation, it may be easier for directors to avoid subsequent investigations into their conduct by utilising the voluntary administration option. Therefore a deed of company arrangement that could provide a marginally better return than under liquidation could be supported by creditors but without their full knowledge of how the directors had discharged their duties to the company in the past…Commonly, directors tend to only seek the protection of a voluntary administration once the Australian Taxation Office has served a statutory notice on the company as a precursor to winding up the company. Also, a voluntary administration prevents a creditor enforcing a guarantee against a director whilst the administration is in force. This allows time for directors to rearrange their affairs (if they have not already done so prior to the appointment of the administration) to the possible disadvantage of creditors.[20]

5.25 An ASC commissioned study of 55 voluntary administrations in New South Wales in 1998 found that the reasons for entering the process varied as follows:[21]

Aim	Number	%
To Restructure	18	33
For liquidation	11	20
To avoid directors' liability for withholding company tax	4	7
Avoid a winding up application to the court	7	13
Avoid consequences of liquidation	15	27

20 *Submission* 28A, p. 11.

21 ASC Research Paper 98/01: A Study of Voluntary Administrations in New South Wales Australian Securities Commission, Sydney, 1998 at pp. 26-27.

5.26 On the basis of this relatively small sample it would appear that only a third of companies are using the procedure to effect a reorganisation. A fifth are using the procedure to initiate a liquidation. The use of the procedure for these purposes does not indicate that the procedure is misused. Nor does the presence of other motives for initiating the procedure point to misuse. The policy favouring reorganisation does not imply that every company is a suitable candidate for it. Companies that are beyond the point of rescue, or that should be brought to an end, should be liquidated promptly and efficiently. Part 5.3A explicitly contemplates and provides a viable route to an orderly liquidation of a company.

5.27 Anderson and Morrison comment:

> …the system itself is designed to encourage the use of the procedure where other possible outcomes of insolvency are identifiable. It is not necessarily therefore an abuse of the procedure to obtain this benefit.[22]

5.28 A number of submissions responded to criticisms that Part 5.3A is a procedure better suited to addressing the financial difficulties of small to medium enterprises and is not suitable for large company failures. Some commentators have argued that a US Chapter 11 model would better address the circumstances of large company failures.[23]

5.29 The IPAA, in response to discussion regarding the restructuring of large enterprises and whether the current insolvency regimes cater effectively for the needs of large insolvency administrations, commented:

> It is the IPAA's opinion that with amendments to the Corporations Act previously detailed in other forums and in this submission, Part 5.3A provides an effective mechanism for dealing with the restructuring of large enterprises.[24]

5.30 Mr Harmer was among the witnesses who pointed out that insolvency procedures including the VA procedure could on occasion be abused. He noted:

> As far as weaknesses [of the voluntary administration procedure] are concerned, any rehabilitation or rescue regime must have some inherent weaknesses because advantage will be taken of any such regime, maybe in hope and expectancy but without, in some cases, a real prospect of rescue or rehabilitation. That is something of the price you have to pay for offering a system that is workable and can be easily applied. In summary, that is what I would say about the regime.[25]

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22 *Submission* 34, p. 13.

23 See for example Geoff Sutherland, 'Australia needs Chapter 11 Code', AFR Opinion, 11 December 2002.

24 *Submission* 22A, p. 3.

25 *Committee Hansard*, 17 September 2003, p. 272.

5.31 Along similar lines, Professor Keay[26] observed:

> Administration is being abused in some situations, but that is not unusual. Most procedures are going to suffer some sort of abuse, but from what I can gather…the procedure is working well. One of the plaudits for it is the fact that the United Kingdom last year decided to change its Insolvency Act to refine its equivalent to voluntary administration, so it is going to be similar to the Australian model.[27]

5.32 An alternative means of appraising the success or failure of the voluntary administration procedure is to compare it to recognisable standards for rehabilitation regimes such as those set by the World Bank in its April 2001 *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*.

5.33 Most comparable countries now include a business rescue scheme in their insolvency regime and for good reason. The rescue of a business preserves employment, potentially provides creditors with a better return based on higher going concern values of the enterprise, potentially produces a return for owners and obtains for a country's economy the benefit of the rehabilitated enterprise.

5.34 The World Bank has stressed that a rehabilitation regime:

> should permit quick and easy access to the process, protect all those involved, permit the negotiation of a commercial plan, enable a majority of creditors in favor of a plan or other course of action to bind all other creditors (subject to appropriate protections) and provide for supervision to ensure that the process is not subject to abuse. Modern rescue procedures typically address a wide range of commercial expectations in dynamic markets. Though such laws may not be susceptible to precise formulas, modern systems generally rely on design features to achieve the objectives outlined above.[28]

5.35 In Principle 17, the World Bank summarises the key design features of rehabilitation statutes. They are:

> To be commercially and economically effective, the law should establish rehabilitation procedures that permit quick and easy access to the process, assure timely and efficient administration of the proceeding; afford sufficient protection for all those involved in the process, provide a structure that encourages fair negotiation of a commercial plan, enable a suitable majority of creditors in favor of a plan or other course of action to bind all other creditors by the exercise of voting rights (subject to appropriate minority protections and the protection of class rights) and provide for

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26 Professor of Corporate and Commercial Law in the Department of Law at the University of Leeds.

27 *Committee Hansard*, 14 August 2003, p. 211.

28 World Bank, *Principles and Guidelines for Effective Insolvency and Creditors' Rights Systems*, April 2001, Executive Summary and Introduction, p. 5.

> judicial or other supervision to ensure that the process is not subject to manipulation or abuse.

5.36 In its essential features, the voluntary administration procedure mostly satisfies this broad design prescription. It provides a flexible and relatively inexpensive procedure which gives a company breathing space so that it can attempt a compromise or arrangement with its creditors aimed at saving the company or the business and maximising the return to creditors. If successful, the agreement will be set out in a deed of company arrangement which binds the company and the creditors. If these attempts fail, the legislation facilitates a transition to winding up.

5.37 The procedure includes conventional features of business rescue systems such as the removal of all powers of management from directors during the administration, and restraints on intervention by creditors (secured or otherwise) seeking to pursue individual rights against the property of the company at the expense of the rescue. It provides access to information by creditors and the opportunity for them to have a say in the outcome of matters in which they have a financial stake, and a debt moratorium which is restricted to a relatively short period.

5.38 In other respects, however, the procedure may be seen to depart from the design features recommended by the World Bank. Firstly, it rejects the court as a significant authority for controlling the economic rescue of the company. Secondly, the trigger for initiation of the procedure can be solely in the hands of the directors. Thirdly, the period for the procedure is set at a relatively short period of 4 to 6 weeks.

5.39 While these features of the regime have been the subject of criticism, in the Committee's view they have proven through a decade of experience to be positive features of the system. Extensive court involvement may serve to increase the expense of the procedure and delay its progress at a critical time. One author has commented:

> There is no assurance that commencement by court application will improve the decision making process either by way of reducing the time taken to make the decision nor by increasing the likelihood of a successful turnaround in the company.[29]

5.40 It is a truism that time is of the essence in a rehabilitation proceeding. Reasonably rigid time limits are necessary to ensure that the process is conducted without delay. Decisions about the continued operation and future of the business or the authorisation of sales and purchases or transactions must be taken as early as possible to ensure that the debtor's business is not disrupted resulting in further decline in the entity's net worth and loss of customers. The short time frame for the procedure reflects a concern to minimise the impact of interference with contractual and proprietary rights established before the procedure commenced.

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29 Anderson, Colin, 'The Australian Corporate Rescue Regime: Bold Experiment or Sensible Policy?', (2001) 10 *International Insolvency Review* 81, 84.

5.41 The Committee considers the VA procedure has been a successful innovation. It should be retained as a central feature of Australian insolvency law. After a decade of operation it appears to be functioning effectively and providing reasonable opportunities for businesses in financial difficulty to reorganise. It generally strikes a reasonable balance between liquidation and reorganisation. In the event that reorganisation or rescue is impossible, the VA procedure permits a prompt transition to a predictable, fair and orderly liquidation procedure in which losses are distributed appropriately and minimised to the extent possible. The flexibility that is inherent in the procedure in most cases achieves a balance between the interests of debtors and creditors. It has become an increasingly popular form of external administration. Voluntary administrations now form a significant, if not a major, part of the practice of most insolvency practitioners.

A new form of administration

5.42 A number of submissions expressed more fundamental criticisms of the VA procedure and suggested an alternative form of administration. Mr Kerr proposed that consideration be given to the adoption of a debtor in possession regime as an option to the VA procedure.[30] Pacific Capital Corporation and the Business Turnaround Association proposed an alternative form of administration that would include features of the US Chapter 11 procedure.[31] They considered that current insolvency laws do not enable or encourage business turnarounds to be realistically considered in the majority of cases when a company is in financial difficulties and proposed policy and legislative changes to support the establishment in Australia of an effective business turnaround industry.

5.43 The key point was that it is normally not possible to rescue a company and perform a business turnaround in the short period of a month, the period in which the voluntary administrator must formulate and present a plan for the company's creditors to consider. In their view, most companies that enter into voluntary administration enter it too late and end up being liquidated.[32] They maintained that:

- Voluntary administration is not strictly an insolvency prevention mechanism. It is a formal insolvency procedure. Where deeds of company arrangement are successful they commonly involve creditors—usually unsecured creditors—having to forgo most of what they are owed. The procedure can only be invoked if, in the words of the Act, 'the company is insolvent or likely to become insolvent at some future time.' [33]

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30 *Submission* 6, p 3. However, see his further comments *Committee Hansard*, 11 November 2003, p 298. See also Mr Potter, COSBOA, supporting consideration of a Chapter 11 approach, *Committee Hansard,* 20 August 2003, p. 248.

31 *Submissions* 17, 18, 18A and 55.

32 *Submission* 17, p. 1.

33 *Submission* 17, p 1; *Submission* 18A, p. 2.

- Voluntary administrators are perceived as being liquidators, not business turnaround professionals.[34]
- Formal insolvency schemes destroy value in companies.[35]
- Directors are invoking the procedure too late to effect a business rescue and avert insolvency and liquidation. Some do so to avert the possibility of actions being taken against them for insolvent trading.

5.44 While conceding that the voluntary administration procedure was an improvement on the more restrictive options of provisional liquidation or liquidation for most insolvent companies, Pacific Capital stated:

> The VA scheme generally relies on performing some 'financial engineering' or selling off the company's assets very cheaply as it is generally impossible to 'turn' a company around and/or promote its sale at a price that gets all creditors paid 100 cents in the dollar in the allowed time. We believe that the vast majority of VAs, which are considered successful, involve creditors (usually unsecured small creditors) having to agree to forgive a majority or substantial amount of the money they are owed.[36]

5.45 Pacific Capital Corporation saw considerable merit in investigating the establishment of a new Turnaround or Insolvency model with some of the characteristics of the US Chapter 11 model. The major difference with Chapter 11 should be that a majority of new directors and a new CEO should be appointed to the company.[37] It envisaged that a new turnaround model would provide for a moratorium on paying existing creditors for 6 months, the appointment of new directors, indemnification of directors and chief executives undertaking turnaround roles.

5.46 Mr Carter of the Turnaround Management Association proposed consideration of a safe harbour from liability for insolvent trading.[38] Pacific Capital also proposed examining the possibility of a Turnaround Panel comprising experienced turnaround professionals to provide advice concerning turnaround and reconstruction issues.[39]

5.47 The Business Turnaround Association put forward a similar and more detailed model. It did not consider that Chapter 11 as it presently exists would be an appropriate model for Australia. It proposed that the Government establish a Turnaround Panel which would oversee the implementation of plans to effect the turnaround of companies. The Panel would decide if there was a sufficient

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34 *Submission* 17, p 1; *Submission* 18A, p. 2.

35 *Submission* 18A, p 2; *Submission* 17, p. 1.

36 *Submission* 17, p. 1.

37 *Submission* 17, p. 2.

38 *Submission* 55, p. 29.

39 *Submission* 17, p. 2.

commercial case for granting a moratorium from unsecured creditors for 6 months to enable the company to undergo a business turnaround. The Panel would impose terms and conditions on any grant including the appointment of new management. Access to the Panel would be limited to companies of a certain age.[40]

5.48 Mr Hedge of the Business Turnaround Association commented that although the voluntary administration system has worked well in many circumstances it is not actually suited to, and was not designed to assist, the greatest number of companies who need the services of a turnaround. In his view there were two fundamental obstacles to those companies facing up to and addressing their problems on a more timely basis. Firstly, there was the fear of the legal and civil repercussions for the individuals who launch an attempt to turn the business around, in the event that that turnaround does ultimately fail and the company becomes insolvent leading to arguments about when the company was insolvent. Secondly, there was the absence of an awareness and culture of turnaround.

5.49 The Committee noted the UK Corporate Voluntary Arrangement (CVA) procedure which is available mainly to small and medium sized companies. Under the procedure the directors of a company can take the initiative in setting up a voluntary arrangement. It allows a company to reach an arrangement with its creditors under the supervision of an insolvency practitioner. It is not necessary for the company to be ‘insolvent’ or ‘unable to pay its debts’ for the procedure to be used. It is generally less complex, time-consuming and costly than alternative procedures. There is an incentive for directors and managers to seek to put a CVA in place as they remain in charge of the company and its affairs. The procedure does not override the interests of creditors. A CVA has to be approved by requisite majorities of creditors and shareholders. A moratorium of 28 days applies where small companies utilise the procedure.

5.50 The Committee considers that the concept of a business turnaround culture has considerable merit especially the incentive it provides for timely intervention by the directors before all hope for rescuing the company has gone. Nonetheless, it does not recommend the introduction of a new procedure along the lines proposed by Pacific Capital and the BTA. The Committee is concerned that a procedure having the features proposed may impact significantly and adversely on the rights of creditors of the company, particularly unsecured creditors. The proposed procedure is a relatively new concept and in some respects departs radically from the VA procedure. Notwithstanding significant differences in the two procedures the policy objectives in favour of the proposed procedure are similar to those that have been advanced in favour of the voluntary administration concept, in particular that its purpose is to encourage directors to give early consideration to the company’s financial difficulty.

5.51 In this respect the proposed procedure and the current procedure seek to achieve similar goals.

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40 *Submission* 18A, p. 3.

5.52 The Committee is concerned, however, to ensure that the VA procedure provides sufficient incentives to companies to initiate the procedure. Mr Crutchfield has suggested that the threshold test for initiation of the procedure by directors ('the company is insolvent or likely to become insolvent at some future time')[41] should be replaced by a test to the effect that 'the company is insolvent or may become insolvent'.[42] The Committee considers that the threshold test permitting directors to make the initial appointment of an administrator under the voluntary administration procedure could be moderated in order to alleviate perceptions that the VA procedure is only available to insolvent companies.

Recommendation 14

The Committee recommends that the threshold test permitting directors to make the initial appointment of an administrator under the voluntary administration procedure be revised in order to alleviate perceptions that the VA procedure is only available to insolvent companies. The Committee notes the suggestion that the test be reworded to read 'the company is insolvent or may become insolvent'.

Voluntary Administration and Chapter 11 compared

5.53 Australia's voluntary administration procedure has some broad similarities with Chapter 11 in the United States. Both schemes aim to preserve the value of the enterprise where this is likely to be greater than the liquidation value and to rehabilitate businesses in trouble or, when that is not possible, to assist in an orderly transition to liquidation. In their detailed features and underlying rationale, however, the procedures differ markedly. The Chapter 11 procedure embodies a quite different approach to the question of business rescue and rehabilitation underlining the fact that there are widely differing possible legislative models for business rescue regimes.

5.54 The voluntary administration procedure essentially enables a company to activate a moratorium period under the control of an insolvency practitioner for a relatively short period of time in order to enable the parties to take stock of the company's situation at a time of insolvency or anticipated insolvency with a view to determining the most appropriate course of action open to it. It aims to provide an expeditious and relatively inexpensive procedure in which a company may obtain a breathing space. During this period, the company can attempt a compromise or arrangement with its creditors (a deed of company arrangement) aimed at saving the company or the business or maximising the return to creditors. A further policy behind the procedure is to reduce the delay, expense and legalism of extensive court involvement as much as possible. It is not, of course, intended to exclude court involvement. Courts retain a general supervisory role, and play a creative role in the operation and development of the procedure. A number of provisions permit or require court involvement.

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41 Section 436A(1).

42 *Committee Hansard*, 7 August 2003, p. 129.

5.55 The Chapter 11 procedure is initiated by the filing of a petition with the Bankruptcy court. There is no requirement for the debtor corporation to be insolvent or to be approaching insolvency in order to initiate the process. On the filing of the petition an automatic stay is invoked. The automatic stay contrasts sharply with the moratorium initiated by the VA procedure. It is virtually open-ended. Under s 362(c) of the Bankruptcy Code it continues until relief from the stay is ordered by the court, the property is no longer the property of the debtor or the Chapter 11 case is dismissed or closed or a discharge is granted or denied.

5.56 The stay applies to almost all types of action that may be taken against the company. Sanctions are provided for breaches of the automatic stay. The stay binds all creditors both secured and unsecured. A 'party in interest' such as a secured creditor or a landlord may initiate court action to have the stay lifted but the stay will be upheld if the court finds that the debtor company has provided the creditor with 'adequate protection' for their property interests. The court may also grant relief if the debtor does not have any equity in the property and the property is not necessary for an effective reorganisation.

5.57 The procedure places a much greater emphasis than the Australian or UK procedures on rehabilitation and is utilised primarily by commercial enterprises seeking to continue operating a business and to repay creditors through a court approved reorganisation plan. Pre-existing legal rights may be more significantly altered than in Australia. It is a slower process and more expensive, with much greater involvement by the court. Many voluntary administrations may run their full course with no or minimal court involvement.

5.58 Ordinarily, the debtor remains in possession under Chapter 11. The debtor has the first opportunity to propose a reorganisation plan. However, this can take up to three months. This is followed by a further period of sixty days during which shareholder and creditor approval is sought. Often it may take months for a plan to be finalised and only after that finalisation are other parties given the opportunity to propose their own plan. Under voluntary administration, an independent administrator is appointed to report on the affairs of the company to the creditors, and control of the company and supervision of the process passes from the directors to the administrator. Administrators must normally report to creditors within one month on a proposal for the future of the company. The longer time periods involved in a Chapter 11 proceeding necessitate more complex rules concerning the rights of secured creditors, which are not required under voluntary administration.

5.59 A striking difference between the US and Australian rescue models is in the treatment of secured creditors. Under the US model all secured creditors are subject to the automatic stay irrespective of whether enforcement of the security has commenced before the company seeks the protection afforded by Chapter 11. Under the Australian procedure s 440B prohibits the enforcement of a charge during the administration except with the administrator's written consent or with the leave of the court. But this provision is subject to the exceptions contained in Division 7 of Part 5.3A. The main exceptions are:

- creditors who have a security over the whole, or substantially the whole, of the company's property who enforce their charge during the decision period—(generally the 10 days after the administration commences or the substantial chargee has been notified of the appointment of the administrator). Substantial chargees may enforce the charge without regard to the administration. The provisions of Part 5.3A which would otherwise operate to prevent enforcement are inapplicable;

- creditors who have enforced other charges before the commencement of the administration; and

- creditors who have charges over perishable property.

5.60 Further when a deed of company arrangement has been entered into, a secured creditor who has opposed the execution of the deed is entitled to enforce its security unless the administrator applies to a court to prevent the creditor from doing so and can show that the creditor will be adequately protected. An underpinning assumption here, reflected in the statistical data on take up of the VA procedure, is that financial institutions have lent a measure of support to the voluntary administration procedure rather than pursuing radical receivership or liquidation options.

5.61 The US corporate rescue model may be seen to occupy one end of a continuum. It is widely perceived as being one of the most debtor-oriented rescue procedures in the world. The debtor company's pre-petition management usually remains in control for long after the petition is filed. The debtor is granted an exclusive 120 day period in which to propose a reorganisation plan. In contrast, and perhaps at the other end of the continuum, are rescue models such as Germany's that are strongly creditor-oriented. They reflect a policy preference for sale of the business as a going concern rather than rescue, with a view to maximising the returns to what are viewed as the only important stakeholders, the creditors. Under this model the debtor company is excluded from any role in determining its fate. Creditors decide on the best solution and impose it on the debtor company.

5.62 Most submissions that commented on this issue argued strongly against the adoption of a Chapter 11 model. The ABA considered that a US Chapter 11 style administration would be unsuitable for Australia. In its view 'the voluntary administration regime in Australian has worked comparatively well and that any perceived difficulties with the regime can be addressed through ensuring that the right balance is struck between the information needs of creditors, the position of secured creditors and time constraints imposed by the legislation'. Some of the distinguishing features of a Chapter 11 administration and the VA procedure noted by the ABA included:

- Whilst both regimes impose a moratorium on creditors' claims, the voluntary administration regime places tighter timeframes to minimise the inconvenience and prejudice to creditors through the abridgement of their propriety rights and rights accrued under freedom of contract.

- Unlike Chapter 11, under the voluntary administration the secured creditor or chargee retains control over the decision about its security even though there is a time limit affecting the decision whether to enforce the security. This makes it less likely for a chargee to act due to uncertainty and therefore more likely to work with a restructure.

- Under Chapter 11, the company generally retains its own executives to administer the affairs of the company. Under voluntary administration the company's management is assumed by an independent, qualified administrator.

- Quite lengthy timeframes apply to proposed plans for reorganisation that would see a company under Chapter 11 administration having no certainty of future direction for over 6 months and in practice much longer. Under voluntary administration decisions are undertaken more quickly and under the supervision of a qualified independent administrator.

- The Chapter 11 process supports existing management and benefits shareholders, to the detriment of creditors. The investor seems to be preferred over the creditor.

- With the longer timeframe for a standard Chapter 11 bankruptcy protection administration there is the increased ability of management to trade at a loss, thereby dissipating assets available to creditors. Part 5.3A of the Corporations Act imposes personal liability on the administrator for amounts incurred in the course of the administration. This causes the administrator to minimise unprofitable trading. There is less likelihood of assets available to creditors being dissipated.

- Under Australian law there is access to a number of different insolvency procedures. Should administration not be appropriate, there is the possibility of a company/creditor utilising a provisional liquidation, a creditors' voluntary winding up and even a receivership. The current regime is adaptable to the given situation.

- Chapter 11 has the potential to distort significantly a competitive market and disadvantage competitive businesses that have run their businesses efficiently and properly. The standard prolonged timeframes under Chapter 11 increase this potential.

- If a secured creditor is unable to exercise the option of replacing a client's existing management with an administrator [under a Chapter 11 style administration], there will be an appreciable rise in credit (and regulatory) risk accompanied by stricter terms and conditions on lending which would extend to the price and availability of finance.[43]

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43 *Submission* 28A, pp. 7-9.

Two of the major concerns expressed about a Chapter 11 regime were: the company remaining in the hands of the debtor and the length of the process. It was not just financial institutions that expressed concerns about a Chapter 11 rescue model.

5.63 Anderson and Morrison commented:

> …there is considerable disquiet about the potential use of the Chapter 11 procedure to delay inevitable liquidation and the fact that there is a presumption of the debtor remaining in the possession of the corporate assets.[44]

5.64 Professor Keay cited the opinions of a number of practitioners and academics on Chapter 11:

> One of these…is the debtor in possession principle. Some people feel that you should not leave the people who have made a mess of things in control of the company. Whilst, of course, there is a bankruptcy judge who oversees things, he or she cannot be involved in the day-to-day affairs of the company. I must say that I have a concern about that…[I]f a court hears enough evidence to suggest that there is a problem with leaving the directors in control, they can appoint a trustee who effectively is like an insolvency practitioner in Australia and that trustee can come in and run the company. But it is done very infrequently.[45]

5.65 He favoured the general tradition in the Anglo-Australian systems of appointing an independent person:

> The voluntary administration process is a better process, in my view, particularly because of the fact that someone independent is running the show. I think that is appealing for creditors.[46]

5.66 He also considered that there were indications Chapter 11 is being used in an improper way to try to avoid liability not only to tort claimants but also to employees who are under employment contracts that have been formulated with unions.

5.67 Similarly, Mr Harmer expressed doubts about the appropriateness of a Chapter 11 model for Australia. He also noted the importance of having a third independent party taking charge:

> I am, of course, familiar with the Chapter 11 regime. I doubt that it is well suited to Australia, primarily because it relies upon the development that has come in America of a kind of market-force process. The American regime strikes me as one which is almost like Economics 101. It is a matter of supply and demand. It is a matter of the involvement of market forces. So on the one hand you have the debtor, involving the shareholders, the

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44 *Submission* 34, p. 15.

45 *Committee Hansard*, 14 August 2003, p. 215.

46 *Committee Hansard*, 14 August 2003, p. 216.

> management, and on the other hand you have the various groups of creditors with particular interests that are motivating them, particular interests that they seek to have enhanced or protected. Into that melting pot these interests come together in order to broker some type of deal.[47]
>
> That has been practised in the United States now for some 25 years and possibly longer. It is something to which they are used. It favours their view that insolvency is not the end of the world. For their purposes I am sure it works reasonably well. I would find it difficult to see it working as well in Australia. One major reason for that is that this country has been long used to the idea of an independent person who is interposed, as it were, between the competing interests and is primarily there to benefit, as a whole, those interests. For Australia to do away with that would be certainly breaking new ground. I do not think I can say that it would not work, but there is some doubt that it would work as well and as practically speaking as the Americans claim their chapter 11 works.[48]

5.68 To the same effect, Mr Ipp of the Australian Institute of Company Directors expressed the following view about Chapter 11:

> My personal view is that the US chapter 11 scheme would not be something that Australia should adopt. Obviously we have a creditor in possession regime in Australia and the US chapter 11, as you know, is a debtor in possession regime. They are fundamentally different. I think one of the important things to realise is that, if you adopt the US chapter 11 procedure, you are maintaining control in the hands of the directors. In this current climate, where there is a lot of focus on the conduct of directors, if that were to be adopted it would fly in the face of the current flow of thought on the conduct of directors and their responsibilities. In effect, you would be handing back the failed business to the directors, which in some respects might be seen as being a step backwards in the way Australia's insolvency laws are going.[49]

5.69 Mr Ipp also commented on the different manner of supervision of the Chapter 11 procedure:

> One of the other major things to bear in mind about the US chapter 11 procedure is that it requires the court to control the process, and that is a system that Australia, in a way, had prior to the introduction of the voluntary administration regime. One of the main criticisms prior to the introduction of that regime was that the court controlled the process. It was too expensive—the barriers to entry were too high—and there was too much delay. If one were to adopt a US chapter 11 procedure in Australia, you

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47 *Committee Hansard*, 17 September, 2003, p. 272.

48 *Committee Hansard*, 17 September, 2003, p. 273.

49 *Committee Hansard*, 11 November 2003, p. 287.

> would simply bring into play all those issues again. My personal view is that I would not support that introduction.[50]

5.70 Supporting this view, Vanessa Finch referred to the problems in having the managers remain in control throughout the proceedings:

> The expenses of litigation tend, furthermore, to be fuelled where the DIP [debtor in possession] approach leaves managers in control of a company since this may produce a lack of trust between creditors and management: a position that often gives rise to litigation that stands to be paid for out of the estate.[51]

5.71 The length and cost of the process was also a concern. A procedure based on Chapter 11 is subject to uncertain time limits and may be open to abuse. It may be used by the management of insolvent companies to delay and/or avoid paying creditors rather than to reorganise. It may be too time-consuming, costly, and too friendly towards debtors.

5.72 The average duration of Chapter 11 proceedings is 18 months and when a firm moves from a Chapter 11 procedure to liquidation under Chapter 7 the further process takes an average of 14 months.[52] Professionals have few incentives to act quickly under Chapter 11 proceedings and professional fees have been estimated to use up between 3 and 8% of the firm's assets.[53]

5.73 Overall, the current procedure in Australia has strong support. The IPAA summarised the attitude of most witnesses that wholesale changes are not required to the voluntary administration regime nor the introduction of a new regime. It told the Committee:

> Our members are at the coalface and it is their opinion that, with the assistance of the court, the voluntary administration process has the flexibility to be used effectively in the restructuring of larger enterprises. The IPAA notes that this issue is also being considered by CAMAC in their review of the restructuring of large enterprises.[54]

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50 *Committee Hansard*, 11 November 2003, p. 287.

51 Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles,* Cambridge University Press, (2002), p. 200.

52 Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles,* Cambridge University Press, (2002), p. 200.

53 Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles,* Cambridge Uni Press, (2002), p 200; but cf Corporations and Markets Advisory Committee, *Rehabilitating large and complex enterprises in financial difficulties*, Discussion Paper, September 2003, p. 7: 'percentage costs have been progressively reducing since the early 1980s as the judicial procedures under Chapter 11 have become more streamlined.'

54 *Committee Hansard*, 19 August 2003, p. 219.

5.74 The Committee understands that a fundamental difference between the Australian and the American business rescue models lies in the manner of supervision of the procedure. Australia and England have traditionally preferred to rely on an independent insolvency practitioner to conduct the administration or the rescue process. Leaving the old managers in charge of the firm may, in the eyes of some, be unwise. While this point of difference should not be overstated (financial stress is not always a result of poor management and creditor pressure will tend to remove poor managers at an early stage in the process in any event) in the Committee's view there are advantages in terms of speed, cost and flexibility in placing greater reliance on an administrator's discretion and the agreement of the creditors.

5.75 The Committee is not persuaded to the view that an insolvency procedure modelled on Chapter 11 of the US Bankruptcy Code is appropriate for the Australian corporate sector. Nor does it consider that wholesale amendments to the voluntary administration procedure to conform with Chapter 11 have the potential to make a significant improvement in outcomes that are presently achievable under the VA procedure.

5.76 The Committee notes that the Advisory Committee is currently inquiring into the rehabilitation of large and complex enterprises with a particular emphasis on the US business rescue model in Chapter 11. This report may well find advantages in incorporating elements of Chapter 11 into Australia's insolvency laws particularly for larger enterprises. It had not reported by the time this report was finalised.

5.77 The Committee in this chapter has come to the conclusion that the VA procedure is well supported by the corporate sector and that it provides an adequate range of opportunities to address the many difficult and diverse problems that arise in the circumstances of business failure. The following chapter continues its examination of the corporate voluntary administration procedure. It considers the scope for meaningful participation by creditors in the voluntary administration and other insolvency procedures.

CHAPTER 6

THE RIGHTS OF CREDITORS—MEETINGS, VOTING AND ACCESS TO INFORMATION

6.1 The VA scheme attempts to meet a wide range of expectations. It aims to permit quick and easy access to the procedure, ensure timely and efficient administration of the procedure and afford sufficient protection for, and facilitate participation by, all those involved in the process. It also aims to provide an environment for a fair negotiation of an optimal administration outcome. The scheme allows the parties involved to decide whether to liquidate or adopt a rescue plan, enables a suitable 'majority' of creditors in favour of a plan to bind all other creditors by the exercise of voting rights, and provides for a measure of judicial oversight to ensure that the process is not subject to manipulation or abuse. For creditors to effectively realise the goals of the scheme, it is vital that they be properly informed about the company's position and prospects. The first and second meetings of creditors are of central importance to creditors as a means of protecting their interests.

6.2 This Chapter reviews concerns raised in submissions about creditors' meetings under the VA procedure, and the capacity of creditors to participate effectively in the resolution of matters in which they have a financial stake.

Creditors' meetings

6.3 On appointment an administrator assumes control of virtually all aspects of the company's activities during the course of the administration. The administrator has many critical tasks to perform and the time period within which these tasks must be carried out is considerably constrained.

6.4 The administrator must hold a first meeting of creditors within five business days after the administration begins[1] and a second meeting to determine the company's future within 28 days (in the usual case) or 35 days (where Christmas or Easter intervenes) of his/her appointment.[2] The first meeting gives creditors the right to decide whether to appoint a committee of creditors but, more importantly, the right to remove the administrator from office and appoint another insolvency practitioner as administrator. The purpose of the second meeting is to determine the future of the company. The second meeting is the more significant one.

6.5 While there is the ability to increase the period for the conduct of the second meeting beyond the standard period of 28 days the underlying aim of the legislation is to have a quick and effective procedure for addressing the company's insolvency. This

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1 Section 436E(1)-(2).

2 Section 439A(1).

has implications for the efficacy of the procedure and the effective participation by creditors.

6.6 The conduct and timing of these two meetings are critical in determining the scope and quality of creditors' rights under the voluntary administration procedure. As well as the timing of the meetings, other aspects of key importance to creditors include the level of information available to creditors given timing constraints, the transparency of the procedure and the manner in which decisions are made and how voting by creditors is conducted and voting rights allocated. The Committee looks at each issue in the context of the first and second creditors' meetings.

The first meeting

6.7 A number of submissions raised concerns about the first creditors' meetings which include:

- the timeframe for the first meeting which may limit the ability of administrators to gather and make available useful information to creditors; and
- the adequacy of the information provided to creditors on which they rely to make the central decision of whether to endorse or replace the administrator.

6.8 Many submissions were of the view that the timeframe for convening the first meeting was too short. Mr Andrew Sellars of the Treasury Department summed up the main concerns:

> The criticism of the first meeting is that the time frame is very short—it occurs five days after the appointment and many creditors may not have the opportunity to assess the merits of the appointee in that time. There is an opportunity to reassess but only at the end of the administration period. The suggestion that there should be more opportunity has been considered by CAMAC and I think it is worthy of consideration. The only consideration that I would note is that, if administrators are allowed to be changed too often, there is a concern about the repeating or doubling up of work and costs.[3]

6.9 Professor Keay commented as follows on the first meeting:

> In relation to the time set for the first meeting, it is probably trite to say that the meeting schedule period is very tight. Even where you have a small to medium sized company, it is sometimes difficult for the administrator to comply with the necessary procedure…The problem is obviously the time constraints. As well, all that happens at the first meeting is that the administrator will have his or her position confirmed and the creditors will

3 *Committee Hansard*, 26 June 2003, p. 22.

> decide whether they form a committee of creditors…There is usually no information the administrator can give to the creditors at this early stage, save for very preliminary thoughts. Probably the best the administrator can do is outline the procedure, which can be very useful for creditors. But one wonders whether this is going to be a very useful meeting, given it is only a few days into the administration.[4]

6.10 QBE Trade Credit expressed similar concerns:

> The holding of this first meeting of creditors within 5 business days of the appointment of the VA is too short a time considering the distance many creditors need to travel to attend. In fact in many cases that we have encountered often the notice of appointment and the advice of the first meeting hasn't reached the creditor in time to attend. This first meeting affords creditors their one and only real opportunity to remove the VA if the creditors suspect that there is not total independence between the Insolvency Practitioner and the company.[5]

6.11 It supported an extension of the first meeting to eight business days to allow creditors to be sufficiently advised on time. The NSW Division of the Australian Institute of Credit Management supported extending the time for holding the first meeting to eight business days and allowing five business days notice to creditors. It considered that the present time frame for holding meetings was insufficient for the administrator to make a meaningful assessment of the company's prospects for survival and for him/her to get all necessary information to creditors.[6]

6.12 Mr Lucas also commented on the time frame for the conduct of meetings:

> The VA process was designed to be a fast process of reviewing a company's position. The timeframes as set out in the Act now are extremely tight and are often difficult to achieve. There is no doubt that a fundamental objective of the VA provisions is the speed…It is my view that the VA regime should be altered to realise the commercial reality that time constraints are too tight.[7]

6.13 One submission argued that the first meeting achieves little if anything and proposed that it be abolished in its current format:

> A first meeting should be held at a later time sufficient to allow the administrator to report in a meaningful way to creditors (say, min 2 weeks, max, 4 weeks). With respect to small administrations where the result is inevitable and there is no chance of a deed being put forward e.g. the

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4 *Committee Hansard*, 14 August 2003, pp. 210-11.

5 *Submission* 49, p. 2.

6 *Submission* 54, p. 2.

7 *Submission* 33, p. 3.

company has ceased trading, there should be the option of being able to proceed straight to liquidation at this early stage.[8]

6.14 A contrasting view was expressed by Mr Zwier:

> I firmly believe it is important to have a meeting as soon as practicable after a company goes into voluntary administration. I believe it is in the interests of every class of creditor and also in the interests of the voluntary administrator. I do not personally believe that five days is too short a period of time. It puts practitioners under a deal of pressure to comply with that time frame, but so be it. It is important for stakeholders to understand what they are now dealing with with the company. Creditors can easily be brought into a meeting by telephone hook-up. In Ansett, we used the Webcast successfully—I think it was the biggest Webcast ever. There is no reason why five business days cannot be complied with.[9]

6.15 Mr Crutchfield agreed:

> I am in favour also of the short time periods in the part. We all know that the more time you have to do something the more time you take, and the creditors pay for that.[10]

6.16 Jones Condon also noted advantages in an early meeting:

> It is important for an Administrator, the company/directors and creditors to know as soon as possible whether the current Administrator will continue. If a company is trading on and a proposal is to be submitted by the directors, a number of significant decisions will need to be made and possible immediate significant costs incurred. Accordingly, it is imperative that the Board and the Administrator know his/her security of tenure as soon as possible. In the five business days leading up to the first meeting of creditors, the Administrator would have made significant inroads in relation to trading on, assessing the company's financial position and proposal, communications with all relevant parties including creditors, suppliers, landlords, secured creditors, employees and potential buyers of the business.[11]

6.17 Mr Ipp stated his view that once a company goes into administration, creditors are anxious to see that somebody has taken control:

> A lot of emotion is involved. They want to attend some formal meeting and, if that occurs very quickly, that often provides an environment for them to obtain information that they would otherwise not get. So I think that,

8 *Submission* 19, p. 2.

9 *Committee Hansard*, 7 August 2003, pp. 126-27.

10 *Committee Hansard*, 7 August 2003, p. 127.

11 *Submission* 12, p. 5.

> although the five-business-day period is rather short…I would not suggest an altering of the five business days.[12]

6.18 Crutchfield's *Corporate Voluntary Administration* points out that the first meeting serves the important purpose of giving the creditors the opportunity to see and hear from the administrator and have the administration process explained to them. The Advisory Committee also notes that it is an opportunity for creditors to find out what has happened to the company and, if possible, get some indication of their prospects for payment.[13] There is no express obligation to explain the process to creditors.

6.19 Another practical consideration in extending the period for holding the first meeting is that the longer an administrator has spent on an appointment the less likely creditors might be to replace him/her since that person would have become familiar with the company's affairs, and a new appointee would need to go through that process again. Extending the procedure's timeframe may reduce its efficiency and make it more expensive.

6.20 A longer period for holding the meeting, however, would give creditors more time to prepare for the meeting, especially to consider whom to appoint as an administrator, and would also give the administrator more time to collect and collate information for creditors. This would allow both creditors and the administrators to be better informed about the state of the company's finances.

6.21 The Committee accepts that it is essential for the creditors to give their imprimatur to the process and considers that the first meeting should be retained. It is aware of the difficulties in preparing adequately for the meeting. While it appreciates that a fundamental objective of the VA provisions is speed, it considers that extending the timeframe for holding the first meeting has significant implications. The moratorium that is initiated by the voluntary administration procedure represents an abridgement of the proprietary rights of creditors and freedom of contract. An extension of the timing of the procedure would further curtail such rights.

6.22 The Committee, however, considers that the timeframe for the meeting may be extended marginally. The Committee does not favour a lengthy extension. It should be aligned with other features of the procedure, such as the requirement for directors to provide a statement about the company's business, property, affairs and financial circumstances within the proposed eight business day period, i.e. within seven days after the administration begins. The holder of a charge over all or substantially all of the property of the company has 10 business days to decide whether to enforce the charge. These chargees often await the outcome of the first meeting before making this decision.

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12 *Committee Hansard*, 11 November 2003, pp. 287-88.

13 *Corporate Voluntary Administration*, para 2.7.

6.23 The Advisory Committee also considered that any adjustment to the timing of the first meeting should not be substantial. It recommended that the time for holding the first meeting should be increased to eight business days after the beginning of the administration, with five business days notice of the meeting to creditors. The Committee considers that this is an appropriate extension. It believes that the extra time for convening the first meeting will enhance the availability of information to creditors and allow them time to prepare for the meeting.

Recommendation 15

6.24 The Committee believes that the first meeting of creditors should be retained but the time frame for the meeting be extended. It does not favour a lengthy extended period. The Committee recommends that the first meeting be held within eight business days after the beginning of the administration with a requirement for five business days' notice of the meeting to creditors.

The second meeting

6.25 The second meeting of creditors sets the timing for the most critical milestone in the administration of the company, the making of a decision about the future of the company. This decision rests with the company's creditors. The role of the administrator is to provide the information that assists the creditors but it is their decision that determines the fate of the company. It is implicit in the VA procedure that creditors have the major financial interest in the insolvent company. The interests of shareholders are assumed to be of secondary importance. Division 5 of Part 5.3A lays down the procedure by which this major decision is to be made by the company's creditors.

6.26 The second meeting of creditors must be held within five business days after the end of a 'convening period'. The convening period effectively sets the timeframe for, and thus an important limitation on, the administration. Section 439A(5) defines the 'convening period' to be:

> (a) 28 days—if the administration begins on a day that is in December, or a day less than 28 days before Good Friday; or
>
> (b) 21 days in any other circumstance.

6.27 In effect the second meeting must be held within four weeks of the commencement of the administration or, if the administration begins before Christmas or Easter, five weeks from the beginning of the administration (unless the court extends the convening period).

6.28 The period of the administration may be extended by the creditors agreeing to adjourn the meeting under s 439B for a period of up to 60 days. Also the court has power to extend the convening period under s 439A(6) and pursuant to its general powers under s 447A.

6.29 No guidelines are laid down as to the matters that a court should consider in hearing an application for an extension of time. The courts have emphasised various factors in considering applications for extensions including the need for speedy administrations and meaningful information to creditors.

6.30 The major concern highlighted in submissions about the timeframe for the second meeting is that it limits the ability of the administrator to carry out a proper investigation of the company's affairs. A longer period of time for holding the second meeting may give an administrator more time to conduct an examination of the company's financial circumstances and consider the best options for the company's future. The problem is more acute in the case of a large company whose affairs are complex. In the case of small companies the records may be inadequate or non-existent. Administrators can and commonly do apply for an extension of time for convening the major meeting.

6.31 Witnesses suggested that extending the statutory time frame for the conduct of the second meeting of creditors to determine the company's future would enable more meaningful information to be provided to creditors. Indeed, creditors reported personal experiences of inadequate notice of the second meeting. Ms Elizabeth Fullerton commented about an administration in which she was a creditor:

> The information upon which the vote for the DoCA was to be based (as the Deed itself had not yet been written) was delivered less than one working day before the meeting was to take place. This effectively prevented employee creditors based in Melbourne (and therefore unable to attend the meeting in Sydney) from participating.[14]

6.32 Various suggestions were made regarding the timeframe for the second meeting. Ernst & Young suggested that the convening period is not sufficient for the administrator to consider properly all the alternatives available nor present a proposal that sufficiently addresses the 'work out' scenario contemplated by Part 5.3A. In its view:

> …consideration should be given to allowing creditors to decide the length of the convening period at the first meeting of creditors or subsequently by resolution. This would avoid the expense of court applications and court time and allow each company to be considered on its complexity and circumstance. Court application should be a last resort by an Administrator.[15]

6.33 QBE Trade Credit stated that the requirement to hold the second meeting within 28 days effectively means that notices and information for creditors regarding any proposal must be sent out 21 days after the initial appointment. This means that

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14 *Submission* 31, p. 3; See also in support *Submission* 36, p. 4.

15 *Submission* 21, p. 2.

the administrator has only 15 days after the first meeting to investigate the company's affairs and provide a sufficiently detailed report to creditors. It commented:

> We believe that 15 days is too short and should be able to be extended, when required, in an efficient and cost effective way.[16]

6.34 The IPAA proposed that the law allow creditors to extend the convening period by resolution at the first meeting of creditors to a maximum period of 90 days. It noted that the voluntary administration process was designed to have minimum interaction with the court.[17] Mr Lucas pointed out that an extended timeframe for the VA process would greatly improve the prospects of adequate disclosure of the terms of deeds of company arrangement.[18]

6.35 On the other hand, the Australian Credit Forum (ACF) proposed no change to the timing of meetings. It considered that one of the benefits of the voluntary administration process is quick resolution.

6.36 The Advisory Committee recommended that the period for holding the major meeting should be extended to 25 business days, with a new convening period of 20 business days. The Committee agrees that this is an appropriate extension. While there was little discussion of the adjournment period, the Committee, in light of the range of concerns about the limited timeframe for the conduct of the second meeting, is not persuaded that the current 60 day maximum time for which creditors can adjourn meetings should be changed.[19]

Recommendation 16

6.37 The Committee recommends that the period for holding the second meeting of creditors be extended to 25 business days with a new convening period of 20 business days. The adjournment period is to remain at 60 days.

Information available to creditors

6.38 One of the prime functions of an administrator is to investigate the company's affairs and form an opinion about which of three future courses would be in the best interests of creditors—execute a deed of company arrangement, end the administration or wind up the company. The administrator must also report to creditors his/her assessment of the company's financial circumstances and his/her opinion as to the most appropriate course to adopt and the reasons for that opinion. If the recommended course is to execute a deed of company arrangement, the administrator must provide details of the proposed deed: s (439A(4)).

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16 *Submission* 48, p. 2.

17 *Submission* 22A, p. 13.

18 *Submission* 33, p. 9.

19 Section 439B(2).

6.39 The law provides little guidance on the content of the reports to be provided to creditors for the meeting that will determine the company's future or the details of the proposed deed of company arrangement. There are concerns that the content and quality of reports to creditors and the information about the courses of action open to them is uneven or inadequate. The contents of proposed deeds are not, in some cases, being provided. Submissions reflected these concerns and proposed a range of responses to them.

6.40 The ASC Research Paper 98/01 proposed that a detailed check list of matters be prescribed for the purposes of s 439A(4) and that the contents of the statement setting out the terms of the proposed deed of company arrangement should be specified. The Advisory Committee expressed some concern about the inclusion of a detailed check list of matters to be covered in the report. In its view, it was contrary to the move to general disclosure requirements in the Corporations Act and may reduce the flexibility of administrators in preparing reports. The Advisory Committee proposed incorporating in the law an additional principles-based requirement that administrators include in their reports 'any other matter material to the creditors' decision'.[20]

6.41 The Committee also supports this approach rather than the prescription of a detailed check list of matters.

6.42 The IPAA commented that the provision of information to creditors had been addressed by the release of its Statement of Best Practice: Content of Administrators Report pursuant to s 439A(4). It said that the purpose of the Statement of Best Practice was to provide guidance to an administrator in fulfilling his/her statutory responsibilities under the law, specifically in preparing the administrator's report on the company's business, property, affairs, financial circumstances and proposal for a deed of company arrangement. The Committee accepts that the Statement serves to enhance the transparency of the VA procedure. It considers, however, that the requirement is of sufficient importance to be legislated for, given that not all insolvency practitioners are members of the IPAA.

Recommendation 17

6.43 The Committee recommends that the administrator's report to creditors at the second meeting of creditors be required to include 'any other matter material to the creditors' decision'.

Recommendation 18

6.44 The Committee further recommends that ASIC publish a guidance note to assist administrators in ensuring that administrators include all matters material to the creditors' decision in their administrator's report.

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20 The ASC Research Paper 98/01, p. 30.

The decision period

6.45 Creditors who have a security over the whole, or substantially the whole, of the company's property may enforce their charge during the decision period—generally the 10 days after the administration commences or the substantial chargee has been notified of the appointment of the administrator. Substantial chargees may enforce the charge without regard to the administration and the provisions of Part 5.3A, which would otherwise operate to prevent enforcement and are inapplicable.[21] The right of a substantial chargee to enforce its security within the decision period constitutes the most important exception to the moratorium provided under the VA procedure.

6.46 Mr Crutchfield questioned the right of a (substantial) secured creditor to enforce its charge before the administration commences or during the decision period, in particular if that right were based on the impact on the availability of credit:

> …secured creditors, holders of fixed and floating charges—ought to be bound by the voluntary administration provisions. The hoary old chestnut that interest rates would go up is just an in terrorem threat; I do not think that is true at all. In the home of banking they have now done it and it has been that way in the United States ever since chapter 11, so, in my view, that should happen.[22]

6.47 A substantial chargee is in a unique position. The enforcement by the secured creditor of a charge or charges over the whole, or substantially the whole, of the company's property does not bring the administration to an end. Once written notice of enforcement is given to the administrator, the whole, or substantially the whole, of the company's property will be under the control of the chargee, or a receiver appointed by the chargee and the administrator will effectively have no assets to administer and no indemnity out of the assets of the company subject to the charge. In practice, therefore, potential administrators may be likely to ascertain the attitude of such a chargee to an administration before accepting an appointment as an administrator.

6.48 The Committee considers that the substantial chargee should continue to be able to enforce its security within the decision period. This feature of the scheme provides an incentive for substantial chargees to participate in the voluntary administration. The statistical data on take up of the VA procedure suggests that financial institutions have lent a measure of support to the voluntary administration procedure rather than pursuing radical receivership or liquidation options. Removal of

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21 Section 441A.

22 *Committee Hansard*, 7 August 2003, p. 124. See also Anderson, Colin, *Commencement of the Part 5.3A Procedure: Some Considerations from an Economics and Law Perspective*, 9 ILJ 4 arguing that 'the power of a secured creditor to appoint an administrator, who would have a charge over the whole, or substantially, the whole of the property of the company, is not justified'.

this right may have the effect of encouraging financiers to take premature action to protect their security or preclude a voluntary administration.

6.49 The ABA advised that 10 days is often too little time for this important decision to be made. It is:

> …insufficient for a chargee to make a proper assessment of the risks to assets that are subject to the security and whether the chargee creditor should appoint a controller (i.e. appoint a receiver and manager or enter into possession of the security property itself).

6.50 The ABA proposed that the decision period should be extended to 15 business days. In its view the extra time would provide a better opportunity and basis for more accurate assessments to be made by both the chargee and the administrator on the future prospects for the company and the effect that continuing administration would have on the assets covered by the security.

6.51 The Committee does not support an extension of the 'decision period'. It considers that, though the 'decision period is restricted', the timeframe for other aspects of the procedure for other creditors is restricted also. Further secured creditors are able to monitor the financial standing of a company and the effectiveness of their security on an on-going basis including prior to the commencement of an administration.

6.52 The ABA also proposed that the Act be made clearer so that under s 440B the written consent of an administrator to the chargee enforcing its charge is able to be given by the administrator during the decision period so that the chargee is free to act upon that consent at a later time after the decision period has expired. The Committee considers that the scope of s 440B is in the first instance a matter for a court. It would seem, however, that the interpretation proffered would negate the purported restriction on substantial chargees making a decision only during the decision period. The Government may wish to clarify the operation of s 440B.

6.53 The ABA proposed that if the administrator forms the intention within a secured creditor's decision period to seek an extension of time for convening the second meeting of creditors, the administrator should be required to communicate this to the secured creditor. It argued that the fact that the administration may be extended would be a relevant consideration for a secured creditor in deciding whether to enforce its security over the company's property. It is relevant because of the potential risk to the value of the assets of the company in the extended period of the administration.

6.54 The Committee is concerned that a requirement of this kind would impose too great a restriction on the administrator's discretion.

Voting at meetings

6.55 There are a number of decisions to be made by creditors under the VA procedure. The decision as to whom to confirm as administrator and the decision whether to attempt to rescue the company through a deed of company arrangement or by placing the company in liquidation are among the most important ones.

6.56 The law sets out the procedure for voting by creditors where such decisions are to be made. The rules for voting set out in the Corporations Regulations apply generally to the convening and conduct of, and voting at, meetings of creditors, members and contributories of a company under the VA procedure and in a winding up. They also apply to meetings of creditors held under a deed of company arrangement. The main features of these rules in their application to the VA procedure are as follows:

- The administrator chairs the meeting.
- A resolution may be carried on the voices. However, a poll may be demanded by the chair, or by at least two persons present in person, by proxy or by attorney who are entitled to vote or by a person representing not less than 10% of the total voting rights of persons entitled to vote at the meeting.
- Where a poll is demanded a resolution is determined by simple majority by number of creditors and value of debts owed. If there is a deadlock between the majority in number and the majority in value of creditors voting, the resolution is not carried. In that event the administrator chairing the meeting will have a casting vote.[23]

6.57 This method of voting has been criticised. Some submissions argued that it leaves too much power in the hands of the administrator. It is not uncommon for there to be a deadlock between the majority by number and the majority by value vote.

6.58 The exercise of a casting vote in relation to the removal of the administrator at the first meeting of creditors, the approval of a deed of company arrangement and the approval of the administrator’s remuneration, may involve a conflict of interest on the part of the administrator. The law provides that the exercise of a casting vote by the Chair can be reviewed by the court on the application of a dissatisfied creditor.

6.59 The explanatory statement to the Corporations Regulations (Amendment) Statutory Rules 1993 noted two arguments in support of the exercise of a casting vote by the chair:

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23 Regs 5.6.19 to 5.6.26.

> the creditors with a majority in value have such an overwhelming interest that it is inappropriate to allow a majority in number, who do not have the same monetary interest, to carry the day, or vice versa;
>
> and
>
> the inability to arrive at any decision, because of continuing deadlocks, affects the welfare of the company concerned.[24]

6.60 It is arguable, however, that giving creditors by value equal standing to creditors by number downgrades their economic interest. The possibility of a deadlock is not necessarily an argument in favour of a casting vote.

6.61 The Harmer Report recommended that voting in an insolvency administration be by simple majority in number of all creditors present and voting either in person, by proxy, by attorney or by such other means as may be permitted; but that if two or more creditors so request, voting be by majority in number and value. In the event of a deadlock there should be provision for an application to the court by the insolvency practitioner or a creditor.[25]

6.62 The Advisory Committee in its 1996 Discussion Paper proposed that the voting method be changed so that resolutions can be either passed or rejected by creditors representing a majority in value of the company's debt and regardless of their number. This would give greater recognition to the economic interest of creditors. The Advisory Committee noted that many submissions disagreed with this approach. Among the main concerns were:

- this method of voting fails to acknowledge adequately the small creditors, who are often the worst affected (even to the point of bankruptcy) by the insolvency of their debtors and the least able to protect their interests, for instance through litigation;
- it would undermine the confidence of the commercial community in the VA procedure; and
- the proposal would permit a large creditor to force a company into liquidation when it would be in the interests of all other parties to accept a proposal.

6.63 In its Final Report, the Advisory Committee favoured retention of the current law on voting (i.e. majority in value and majority in number required to either carry or not carry a resolution with any deadlock to be resolved by the casting vote of administrators). It also considered that other proposals were unsatisfactory including

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24 Explanatory Statement to the Corporations Regulations (Amendment) Statutory Rule 1993, No 135, para. 111.

25 ALRC Report no 45, Vol. 1, para. 579.

requiring a majority by number and a majority by value in all cases with no provision for a casting vote or permitting a majority in value only where the vote of related creditors are not decisive.[26]

6.64 In relation to voting in corporate rehabilitations, the World Bank *Principles and Guidelines* state:

> The law may provide for classes of creditors for voting purposes. Voting rights should be determined by amount of debt. An appropriate majority of creditors should be required to approve a plan. Special provision should be made to limit the voting rights of insiders. The effect of a majority vote should be to bind all creditors.[27]

6.65 The commentary goes on to note:

> The three main issues that arise with respect to voting rights are whether there should be classes of creditors; what should be the voting rights and powers; and what should be the effect of a majority vote. It is appropriate to provide for classes of creditors when there are divergent legal interests that are to be treated in a different manner, although some jurisdictions appear to function quite well without an immense or any detailed structure or sophistication in this area (e.g. Australia).[28]

6.66 In relation to voting rights and powers the commentary states:

> Voting rights should be simplified—voting by amount of debt rather than number of creditors and requiring approval by an appropriate majority.

6.67 Australian law departs somewhat from the model recommended by the World Bank. It allocates voting rights on the basis of number as well as value. It does not restrict the voting rights of related creditors (insiders). It permits a court to overturn a resolution whose outcome was determined by the votes of related party creditors. It does not make provision for voting by different classes of creditors. Arguably this assists in reducing the cost and length of the procedure. The rights of different classes are protected by other means, for example by allowing deeds to be set aside if they are oppressive or unfairly prejudicial to creditors. The exercise of a casting vote by the chair can be reviewed by a court on the application of a dissatisfied creditor under ss 600B and 600C.[29] Courts also have wide powers to intervene with appropriate orders where the voting at a creditors' meeting is unduly influenced by related parties.

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26 In its Discussion Paper on Rehabilitating large and complex enterprises in financial difficulties CAMAC has foreshadowed a re-examination of this issue: pp. 36-38.

27 See Principle 20 on Features Corporate Rehabilitation and accompanying commentary.

28 See Principle 20 on Features Corporate Rehabilitation and accompanying commentary.

29 Examples of such court reviews are Cresvale Far East Ltd v Cresvale Securities Ltd, (2001) 37 ACSR 394 and more recently Selim v McGrath, (2003) NSWSC 927 (17 October 2003).

6.68 Mr Harmer commented on this aspect of the law:

> We were quite deliberate in not providing for what you might term class warfare in the Australian legislation. We thought this would evolve, that maybe in given cases a wise administrator would clearly create a class of creditors who would otherwise be entitled to priority—class of secured creditors, class of least creditors and so forth. The fact that we did not was simply designed to encourage flexibility in that area and not to get involved in the American manner of dealing with those things. When it comes down to whether the legislation could say more with regard to the particular rights of various types of creditors, maybe that is the case, but I think once you start along that track you almost have to go the whole way and in effect adopt the American system.[30]

6.69 Concerns expressed in submissions about the method of voting include:

- The exercise of a casting vote places considerable pressure on administrators as they have a close interest in the matters to be considered at the meeting. It is questionable whether an administrator should be placed in this position if he/she is to be seen to be an independent person acting for all creditors.[31]
- Voting may be controlled by related parties and the use of proxies. Canvassing for special proxies may be undertaken to ensure that resolutions are determined by the use of the casting vote.
- The right of secured creditors to vote (and not abandon their security) in meetings under Part 5.3A makes little sense from an economic perspective because the secured creditor with a right to take security, even after voting, will not have the same interest in the outcome as will an unsecured creditor who is bound by the deed.[32]

6.70 Mr Colin Anderson and Dr David Morrison proposed that one means of improving the independence of administrators may be to have the administrator's right to a casting vote removed. In the view of the authors, the administrator's right to a casting vote:

> …appears to be done for purely pragmatic reasons—that is to enable a decision to be made and for the decision to be acted upon…It does not appear that there is any sound policy reason for the administrator to have this casting vote. At the same time where a group of creditors have their wishes thwarted by the casting vote, they may readily believe that the

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30 *Committee Hansard*, 17 September 2003, p. 276.

31 *Submission* 34, p. 5.

32 *Submission* 34, p. 6.

administrator is taking sides with the group whose wishes she or he supported.[33]

6.71 They also expressed concern at the division of votes on the basis of number and value:

> The apparent justification for this is that a large group of small creditors should not be swamped by one or two creditors who are owed a large amount. It makes little economic sense though that this should be the basis of the decision making…creditors with the most to lose in a restructuring should have the most votes in a decision about the restructuring. The protection of small creditors should be available through court application rather than an ability to veto the wishes of the majority in every case. That is the right may be exercised where there is unfair discrimination rather than placing creditors owed a relatively small amount in a powerful position in every decision.[34]

6.72 Different views were expressed on the question of the casting vote and the method of voting by Mr Zwier and Mr Crutchfield. In Mr Zwier's opinion:

> In every voluntary administration there is always tension between the different stakeholders and the different types of creditors and there is always the risk, of course, that the employees will dominate by number, or that the bank, which might have a very large debt, will dominate by value. Frankly, I think that the system as it presently stands works well. I have no difficulty with the fact that if there is deadlock an administrator should have a casting vote.[35]

6.73 He went on to state:

> An administrator should be compelled to give reasons for the exercise of the casting vote. Once again, in my view part 5.3A works well on the voting and on the casting vote, because of the general supervisory role of the court. Without that general supervisory role of the court, it would be problematic. It is really very difficult to find a perfect, expeditious way of resolving all of the issues, including all the class issues. I personally think that the present system works adequately.[36]

6.74 Mr Crutchfield concurred suggesting the voting system not be altered.[37]

6.75 The Committee does not have available to it empirical data on the outcome of the second meetings of creditors or the frequency of use of the casting vote at such

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33 *Submission* 34, p. 5.

34 *Submission* 34, p. 6.

35 *Committee Hansard,* 7 August 2003, p 135.

36 *Committee Hansard*, 7 August 2003, p. 135.

37 *Committee Hansard*, 7 August 2003, p. 135.

meetings. Removal of the administrator's casting vote poses some uncertainties. It may make it difficult to obtain approval for deeds of company arrangement or result in fewer deeds being accepted if the default position is conversion to liquidation.

6.76 If the administrator's casting vote is removed there may be calls for the law to provide some other means for resolving creditor voting deadlocks. One possible policy response may be to encourage greater management of the process by the court (and lawyers) in confirming or approving a plan. This would necessitate devising appropriate criteria for a court to consider as a basis for reviewing and confirming a plan. However, such a step would represent a significant departure from the objectives of the VA procedure, which are to encourage a speedy resolution of the company's insolvency and to maximise creditor involvement in the decision making process. A deadlock may be costly for the creditors to make an application to a court to resolve.

6.77 The Committee considers it reasonable to place a casting vote in the hands of an independent administrator who meets high standards of experience and education set by a regulatory authority. The administrator is also closely supervised and/or guided in the exercise of any casting vote by the regulator, decisions of the courts and the ability of dissatisfied creditors to have the exercise of the casting vote reviewed by the court.[38]

6.78 While an administrator's interest in remuneration or retaining his/her appointment raises obvious conflicts of interest, the administrator's interest in the outcome of a vote on the future of the company or in other decisions where the exercise of a casting vote may be exercisable is less clear. The task of devising and implementing a plan for the recovery of a company or arranging for it to be wound up in a manner which maximises the return to creditors and members is a complex commercial decision requiring a high degree of skill and expertise. The insolvency regime aims to locate these skills and expertise in insolvency practitioners.[39] It may not be appropriate to repose what is essentially a commercial decision in a court.

6.79 The Committee considers that the administrator should continue to retain the right to a casting vote in the case of a resolution under s 439C. Different considerations may apply in the case of large and complex enterprises. The Advisory Committee has addressed concerns about the voting rights of related party creditors[40] and the ability of secured creditors to vote for the full amount of their debts in meetings while the company is under administration or under a deed of company arrangement.[41]

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38 As happened in Cresvale Far East Ltd v Cresvale Securities Ltd, (2001) 37 ACSR 394 and, in relation to Pan Pharmaceuticals, Selim v McGrath, (2003) NSWSC 927 (17 October 2003).

39 See ASIC Policy Statements 24 and 40.

40 Corporate Voluntary Administration Report, Recommendation 14.

41 Corporate Voluntary Administration Report, Recommendation 16.

6.80 Notwithstanding the Committee's endorsement of the administrator retaining the casting vote, it has taken a different approach where the exercise of a casting vote in resolutions involves an administrator's remuneration or removal. In such cases, the Committee recommended that the administrator's casting vote be prohibited.[42]

The use of general or special proxies

6.81 The Corporations Regulations prohibit the use of general or special proxies by a person to vote in favour of any resolution which would directly or indirectly place the person or the person's business partner or employer in a position to receive any remuneration out of the assets of the company, except as a creditor rateably with the other creditors of the company.[43] This prohibition applies to both liquidators and administrators. The IPAA notes that as a consequence neither liquidators nor administrators are able to use special proxies to vote in favour of a resolution to approve fees even though the creditor has specifically instructed the liquidator or administrator on how he/she wishes to vote.

6.82 The Advisory Committee recommended in relation to voluntary administrations that any person should be permitted to vote for or against any resolution in accordance with a special proxy, whether or not that vote is to the person's financial advantage (recommendation 17). The IPAA considers that this reform would be appropriate not only for administrations, but also for liquidations. Although this matter did not draw significant discussion the Committee is inclined to agree.

Administrator obligation to preside at meetings of creditors

6.83 Sims Partners noted that pursuant to s 439A, the Corporations Act requires an administrator to personally attend the meeting of creditors convened. Administrators have in the past delegated this meeting to other partners or staff.[44] The courts have determined that this is inconsistent with the Corporations Act. Sims Partners considers that an administrator must be able on occasion to delegate the chair of the meeting to another person in certain circumstances. It proposes that the law be amended to provide that in relation to the second meeting of creditors the administrator is to preside where the meeting is to consider whether to execute a deed of company arrangement unless the administrator is unable to attend due to illness or some other good reason or the creditors so resolve. Where the meeting is delegated, the chair must be a registered company liquidator who has been adequately briefed by the administrator.

6.84 The Committee acknowledges that there may be circumstances where it may be appropriate for the administrator to delegate the chair of a meeting. However, it is

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42 See Chapters 3 and 7.

43 Reg 5.6.33.

44 *Submission* 51.

difficult to define such circumstances with precision. The Committee is not persuaded that an amendment in the terms proposed should be made. It notes that the courts have indicated that they are prepared to relieve administrators from the obligation to attend the second meeting in certain circumstances.

Advertising requirements

6.85 A number of submissions commented on the advertising and Gazettal requirements of corporate insolvency administrations. The CPA considered that it would not be unreasonable to abolish all advertising relative to corporate insolvency in line with the current Bankruptcy law and suggested that consideration could be given to a 'Public Notices' web page.[45] The Committee considers that a review of the advertising requirements should be undertaken with a view to reducing the costs of external administrations.

Recommendation 19

6.86 The Committee recommends that the Government consider alternatives to the current advertising and gazettal requirements for external administrations.

E-commerce and insolvency administration

6.87 The IPAA noted that the process of issuing reports and other notifications to creditors incurs a significant cost in insolvency administrations, particularly in relation to large companies or corporate groups. It proposed that options other than printing and posting reports to creditors be considered.[46] It noted that in the Ansett Administration the administrators estimated it would cost approximately $28 million to send the notice of the second meeting and accompanying documentation to the approximately four million creditors. In Ansett Australia Limited and Mentha 200 FCA 2, the court ordered that written notice of the meeting be posted to as many of the creditors as reasonably practical and that notice of the meeting be published in all major Australian newspapers. It also ordered, however, that copies of the report, the statements referred to in s 439A(4) and the proxy form did not have to be sent with the notice of meeting. They could be posted on two websites provided by the administrators so as to be able to be downloaded by any person accessing the website. The court also required the administrator to maintain a telephone hotline and deliver to any creditor at his/her request by post, facsimile or email a copy of the notice, report, statements and proxy form. The court also ordered that if the meeting was adjourned, the administrators did not have to notify creditors by post if the initial notice advised creditors that they would not be notified of any adjournment and information about the adjournment was published on the websites within 48 hours.

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45 *Submission* 23, p. 10.

46 *Submission* 22A, p. 8.

6.88 The IPAA noted that amended requirements set down in the Ansett case are not going to be cost effective for small insolvency administrations. For the large insolvencies seen in recent times, however, alternative provisions in the Corporations Act may have resulted in reduced costs for the administration and greater effectiveness in communicating with large groups of creditors.

6.89 The CPA also expressed support for the use of a liquidator/administrator's website or some other public website to post all circulars and notices to creditors and members 'provided that the initial notice is despatched by mail, contains advice and information regarding future notices and extends the option for creditors and members to receive subsequent correspondence by mail or by individual e-mail upon request to the principal'.[47]

6.90 Mr Tony McLean highlighted the need to consider the impact of corporate insolvencies on shareholders.[48] He noted that it is important for shareholders to have information about the fate of their companies in external administration. In contrast to creditors, shareholders have limited rights to information. Companies under administration rarely hold AGMs. He urged that progress reports on administrations should be available to shareholders.

6.91 Disclosing entities are not excused from preparing and lodging financial reports or holding annual general meetings when a company is under a form of external administration. ASIC has issued interim class order CO 02/968 to provide financial reporting relief, subject to conditions, for various forms of externally administered companies whose financial years and half-years end on or before 31 May 2003. The Committee agrees that shareholders should have information about the fate of their companies in external administration. The adoption of electronic forms of communication also has the potential to allow for the provision of such information to shareholders at a low cost.

6.92 The Committee notes that the use of e-commerce alternatives and advances in technology to facilitate access to information by shareholders is provided for under the current law. The CLERP 9 Bill proposes extensions of these facilities.

Recommendation 20

6.93 The Committee recommends that the Government consider making technology and e-commerce options more widely available to enhance communication with stakeholders in external administrations and reduce the costs of external administrations.

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47 *Submission* 23, p. 9.

48 *Submission* 5, p. 1 and see www.delisted.com.au.

Alternatives to procedural meetings

6.94 The IPAA commented that there are a number of procedural type meetings that must be held under different forms of external administration which, in a large number of cases, have little value to an administration relative to the cost required to hold the meeting. It cited in particular annual general meetings in members' voluntary and creditors' voluntary liquidations (held pursuant to section 508). In the IPAA's view it is rare that any business is conducted at these meetings. Often members and creditors are encouraged not to attend.

6.95 The CPA also commented that the annual general meeting of members and creditors in a creditors' voluntary liquidation 'rarely attracts a quorum and is generally considered to be an unnecessary drain on funds which may otherwise be distributed to creditors'. It noted that there is no requirement for an annual general meeting in the case of a winding up by the Court.[49] The CPA also expressed support for postal voting (similar to that currently used to determine creditors' wishes under Part IX of the Bankruptcy Act) in cases where voting by creditors is required.[50]

6.96 The IPAA noted that expensive meetings are regularly held to obtain creditor approval for example, to approve the external administrator's fees;[51] to approve a straight forward amendment to a Deed of Company Arrangement;[52] or to approve a compromise of a debt to the company[53] or an agreement over three months duration.[54]

6.97 The IPAA considered that there should be a more cost effective way to determine the wishes of the creditors in such situations. It referred to recent amendments to the Bankruptcy Act in relation to creditors' meetings that, in summary, allow a trustee to hold the meeting by post.[55]

Recommendation 21

6.98 The Committee recommends that the provisions of Chapter 5 be amended with a view to permitting alternative methods of conducting minor procedural meetings.

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49 *Submission* 23, p. 8.

50 *Submission* 23, p. 9.

51 Required under s 473(3) for Court appointed Liquidators, s 499(3) for creditors' voluntary liquidators and s 449E for administrators.

52 Required under s 445F.

53 Required under s 477(2A).

54 Required under s 477(2B).

55 *Submission* 22A, p. 9.

Information available to unsecured creditors

6.99 ASIC makes available to creditors on its website brief general information sheets explaining the three main insolvency procedures—winding up, receivership and voluntary administration. The information sheets are prepared by ASIC and the IPAA. They do not distinguish between the needs of different creditors such as secured creditors (who are likely to be much more conversant with the intricacies of insolvency law and the progress of insolvency procedures than other creditors) and unsecured creditors. A two page summary is devoted to the voluntary administration procedure and a two page summary of the winding up procedure. The information sheet concerning the voluntary administration procedure is described as 'a general information guide only to highlight the differences between various types of appointments or administrations'. It advises that 'creditors should seek their own advice about specific circumstances since this is not intended to be a summary of the law'. Apart from these circulars there is limited information on the ASIC website available to unsecured creditors about insolvency procedures.

6.100 It appears to the Committee that better targeted information for unsophisticated, unsecured creditors should be provided, for example, in line with advice and assistance provided to unsophisticated investors in financial markets. ASIC's Fido website advises that 'ASIC is the consumer protection regulator for financial services'. In this role, we protect investors, superannuants, depositors and insurance policy holders. We also regulate and enforce laws that promote honesty and fairness in financial products and services, in financial markets, and in Australian companies'.

6.101 There may be scope for expanding the information provided, and improving the protection afforded, to unsecured creditors confronting the complexities of insolvency administrations for the first time. It is reasonable to assume that secured creditors will be aware of the implications that business failure has for them. It is desirable that unsecured creditors have a clear and ‘plain English’ understanding of how insolvency laws and processes will affect them and the various options that are available to them.

6.102 Comparable jurisdictions to Australia provide comprehensive ‘plain English’ guides on their websites setting out more comprehensive explanations of the implications of differing insolvency procedures for unsecured or unsophisticated creditors and drawing the attention of creditors to matters that are potentially important in determining how their interests will be affected by the procedure and what issues they will or may be required to consider in the course of the procedure.

6.103 The US Bankruptcy Judges Division’s Public Information Series pamphlet provides basic information to debtors, creditors, court personnel, the media, and the

general public on different aspects of the (US) federal bankruptcy laws.[56] While this pamphlet addresses the more complex US insolvency context dealing with personal as well as corporate insolvency matters, the material on US Chapter 7 (the equivalent of liquidation proceedings in Australia) and US Chapter 11 (the equivalent of the Australian voluntary administration procedure) offers a more detailed understanding of the procedure and the range of issues that unsecured creditors will have to consider.

6.104 Two submissions highlighted the difficulties unsecured creditors (employees in particular), unfamiliar with the intricacies of insolvency law and procedures, face in navigating the various stages of the voluntary administration procedure. Concerns detailed by Ms Fullerton and Mr Bishop included:

- inadequate provision of information about the effect of the deed of company arrangement;
- late provision of information about the deed (limiting the opportunity to evaluate its effect on employee entitlements);
- inadequate information about the impact of provisions of the deed on employees' eligibility for entitlements under the GEERS scheme;
- the inexperience and weak bargaining position of unsecured creditors vis-a-vis insolvency practitioners and their advisers;
- uncertainty as to entitlements to redundancy entitlements;
- uncertainties in lodging proofs of debt;
- the lack of an effective mechanism for questioning proposed deeds or putting forward alternative deeds; and
- the disadvantages faced by creditors who do not have funds to seek legal advice or launch legal actions.[57]

6.105 Mr Bishop noted:

> Creditors often do not know their full rights. An expanded information leaflet listing the rights, non-rights, and responsibilities of creditors, produced by ASIC, should be sent to all creditors. A Frequently Asked Questions document, produced by ASIC, would be helpful for creditors. Insolvency practitioners should be more responsible in getting information to creditors. The information should be timely, should be detailed enough

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56 The US Bankruptcy Judges Division's Public Information Series pamphlet provides basic information to debtors, creditors, court personnel, the media, and the general public on different aspects of the (US) federal bankruptcy laws: 'Bankruptcy Basics', June 200, revised edition, http://www.uscourts.gov/bankbasic.pdf.

57 *Submissions* 31 and 36.

(for example: how to fill in forms), explain clearly what is required of creditors and when.[58]

6.106 The Committee also received numerous complaints about fees charged by insolvency practitioners. Information might address some of the considerations that may be relevant for unsecured creditors to take into account in considering and approving fees in liquidations/voluntary administrations. Unsecured creditors may benefit from clear and targeted advice on matters such as the administrator's role in the procedure, matters that might be necessary to investigate, the implications of a deed of company arrangement for unsecured creditors and the types of deeds in use and the key questions that should be asked about the deed.

Recommendation 22

6.107 The Committee recommends that ASIC provide, from the perspective of an unsophisticated, unsecured creditor who may be affected once only by an insolvency proceeding, a series of Frequently Asked Questions or other suitable materials that address the issues they may need to consider as creditors of a failed company, and which explains the law and outlines options and issues that they may need to address.

6.108 This Chapter has examined the scope for effective participation by differently placed creditors in the voluntary administration and other insolvency procedures. It has recommended that the time frame for the first and second creditors' meeting be extended to allow the administrator to better prepare material for the meetings and to allow creditors time to digest this material in readiness for the meetings at which major decisions are taken. It has also recommended that the administrator's report include any matter that is material to a creditor's decision; that better and more effective use be made of technology in communicating with creditors, that sensible measures be taken to keep costs to a minimum by using alternative methods for conducting minor procedural meetings; and that ASIC assume a more active role in the education of creditors as to their rights and obligations.

6.109 The following chapter considers a further aspect of creditors' rights, the cost of external administrations and the problem of assetless companies.

58 *Submission* 36, p. 8.

CHAPTER 7

THE COST OF EXTERNAL ADMINISTRATIONS

7.1 Under the Corporations Act the costs of external administrations are treated as a priority payment. The unsecured assets of the company are utilised to pay the administrator's remuneration and expenses. There are cases where the remaining unsecured assets of the company have been entirely absorbed for this purpose, leaving unsecured creditors with little or no dividend. Unsecured creditors are understandably concerned about this possibility since, even apart from the cost of the administration of the company, they face the prospect of losses. Their concerns may also extend to overcharging, charging for work that is of a speculative nature or that creditors consider unnecessary or assigning too many or too highly qualified staff to tasks.

7.2 The Committee received numerous comments on fees charged by practitioners. They clearly indicated a widespread perception that fees for insolvency services are high and may be unnecessarily so. This chapter reviews the adequacy of mechanisms for determining fees charged by insolvency practitioners. It also considers the issue of remunerating practitioners for the conduct of administrations which have little or no assets available to fund the administration.

The regulatory framework

7.3 The Corporations Act does not prescribe remuneration levels. Rather it encourages administrators and creditors to reach agreement on the question of remuneration as between themselves. The courts have a general supervisory role in settling disputes over remuneration or in setting remuneration where the administrator and the creditors have not been able to reach agreement or it is not otherwise practicable for agreement to be reached.

7.4 More specifically, under the Corporations Act a voluntary administrator's remuneration may be fixed by the company's creditors at the meeting to consider the administrator's proposal for the company's future or at a meeting to terminate or vary the deed of company arrangement. If no remuneration is fixed by the creditors, the remuneration will be determined by the court on the application of the administrator or deed administrator. Until the creditors or the court determine the remuneration payable to the administrator, the administrator will not be entitled to remuneration out of the company's assets. Further, where the remuneration is fixed by the creditors, any creditor, member or officer of the company may apply to the court to review the remuneration. The court may confirm, increase or reduce the remuneration. Broadly similar arrangements apply in the case of liquidations and receiverships.

7.5 In the case of a receivership, remuneration is ordinarily determined by the appointing creditor. A court has power to fix or vary the amount on the application of a liquidator, voluntary administrator, deed administrator or ASIC. In a compulsory winding up, remuneration is determined by agreement between the liquidator and the creditors or, in the absence of such agreement, by the court. In the case of a members'

voluntary winding up, the company sets the level of remuneration. In a creditors' voluntary winding up, the creditors set the level of remuneration. A provisional liquidator's remuneration is determined by the Court. Liquidators may not be compelled to incur expenditure where there is not enough property for reimbursement but are still required to perform some obligations such as lodging reports with ASIC.

Charging methods

7.6 The usual method for determining remuneration is based on practitioners charging an hourly rate for time spent on the administration (time-costing methods). Other methods commonly used for pricing services are fixed fees and commissions. The 1997 *Report of the Working Party on the Regulation of Insolvency Practitioners* reviewed the features of the three methods of charging, comparing the advantages and disadvantages of each.[1] The Report notes the main reason why time-costing has become the norm:

> Unlike many other service industries, there is a high level of uncertainty at the outset of jobs as to how complex and resource-intensive a piece of work may be until at least some preliminary work has been carried out and, even then, there is the ever-present prospect of new problems arising during the course of the administration.[2]

7.7 But time-based charges can reward inefficiency. Mr Lucas commented:

> There is great debate as to how administrators and liquidators should be remunerated. Creditors are quite often hostile as to the rates that are charged, and it must be admitted that those rates are reflective of the often assetless jobs administrators and liquidators have to deal with, where all their time is written off. It is unfortunate that the common method of remuneration is based on a time spent basis. It can be said that this often leads to inefficiency and may be described as a reward for slow thinking.[3]

Level of fees

7.8 A number of submissions expressed support for a scale of fees as a means of controlling fees. QBE Trade Credit commented:

> We consider that a minimum hourly rate for insolvency administrators should be set down as a guide, similar to that which existed a few years ago. There are many different approaches that may be considered, but at least there should be a guide to the maximum hourly rates able to be charged. Although currently creditors can fix the remuneration of the administrators, creditors are often not in a position to effectively argue or understand the quality or quantity of work that Insolvency Practitioner's perform,

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1 Report of the Working Party: Review of the Regulation of Insolvency Practitioners (June 1997), pp. 155-158.

2 1997 Report, p. 155.

3 *Submission* 33, p. 8.

> especially in the more complex insolvencies. A better alternative may be to link reimbursement to the percentage of funds distributed, or even to the dividend paid to creditors in the same way.[4]

7.9 The Australian Credit Forum also supported upper limits on practitioners' fees which should be set at the first meeting of creditors. Estimates of fees supplied by administrators should cover the period up to the first meeting and the period between the first and second meetings of creditors.[5]

7.10 The *Review of the Regulation of Corporate Insolvency Practitioners* considered the question of the basis of remuneration and noted that:

> The market should be allowed to determine the most cost effective fee systems. However, the Working Party sympathises with the view that the public interest is not necessarily best served by minimising the cost of administrations at the expense of quality.[6]

7.11 The IPAA formerly issued a guide to hourly rates, which was widely accepted as a standard for the industry. The former Trade Practices Commission considered the Guide to be a restriction on competition.[7] From 1 July 2000, the IPAA discontinued its 'Guide to Hourly Rates Scale and Staff Classifications' and recommended that practitioners charge hourly rates in accordance with their own internal cost structures, having regard to the complexity and demands of each appointment.

7.12 The Statement of Best Practice on Remuneration issued by the IPAA recommends that in most insolvency appointments, fees should be based on the time spent at the level appropriate to the work performed. The resolution for remuneration should include a specified amount. Where remuneration is approved prospectively, an upper limit must be included in the resolution of creditors or Committee of Inspection.

7.13 The IPAA Guidelines state that fees should reflect the quality and quantity of work performed, ensuring that the staff mix and average rate is commensurate with the nature and complexity of work done. Alternative methods of calculation, such as a percentage of realisations, a percentage of funds distributed, a lump sum or a combination of methods could be warranted in specific cases.

7.14 Some practitioners defended the level of fees charged in external administrations. Ernst & Young commented:

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4 *Submission* 49, p. 5.

5 *Submission* 53, p. 5.

6 1997 Report, p. 163.

7 Trade Practices Commission, Study of the Professions, Final Report—July 1992, Accountancy, pp 74-83. The 1997 Report reviews criticisms of the former scale of hourly rates: pp. 150-53. The Harmer Report proposed a mechanism for setting and reviewing maximum remuneration scales for insolvency practitioners: ALRC report, No 45, vol 1, para 946-947.

> As a general observation, the risks and costs inherent in an individual acting as an external Administrator have increased substantially since the Co-Operative Scheme Companies and Securities Codes that have been in operation since 1982. Increasing focus on the personal liability of managers and companies for non-compliance with other legislation such as Occupational Health & Safety, Environmental and Fair Trading Laws has resulted in additional expertise and systems to be put in place to manage compliance. Notwithstanding, these almost 'strict' liability laws have resulted in unintended consequences for external Administrators who take possession of assets or trade businesses. Rising insurance premiums, increased vexatious litigation, salary costs, and the investment in IT systems to manage compliance with the Laws continue to impact the costs of Administrations.[8]

Rights of review

7.15 Administrator’s fees may be reviewed by the courts. There is also some limited scope for professional associations and ASIC to review the level of fees. CPA Australia does not become involved in fee disputes. It facilitates mediation in relation to fee disputes noting that mediation is conducted on a commercial basis and must be agreed to by each party. It is unable to appoint a mediator but can supply the names of members who may be approached by the parties. The ICAA advises that it is unable to resolve legal issues and accordingly does not mediate on a fee dispute. A complainant can request the Institute to appoint an arbitrator. ASIC may not itself vary the remuneration of external administrators but it may apply to a court to have the remuneration reviewed in a court ordered liquidation[9] and in a receivership.[10]

7.16 Remuneration of administrators and deed administrators is set by resolutions of creditors or by the court.[11] Where remuneration is fixed by resolution of creditors, the court has power to review the remuneration on the application of the administrator or an officer, member or creditor of the company.[12] However, in the course of the inquiry it was noted that the applicants do not include ASIC. The Committee did not take evidence on this point but, consistent with the above mentioned provisions for liquidations and receiverships, the Committee considers that a court should have the power under s 449E(2) to review the remuneration of administrators and deed administrators on the application of ASIC.

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8 *Submission* 21, p. 4.

9 Section 473(2).

10 Section 425(5).

11 Section 449E(1).

12 Section 449E(2).

Recommendation 23

7.17 The Committee recommends that a court should have the power to review the remuneration of administrators and deed administrators on the application of ASIC.

Disclosures

7.18 Administrators' fees may be fixed by open ended resolution of creditors and ordinarily do not specify an amount or set a limit. This form of approval arguably makes the review of fees by a court difficult and reduces practitioners' accountability for their charges.

7.19 Mr Lucas considered that it was important for there to be adequate disclosure of the quantum of remuneration, the calculation of that remuneration, and the nature of work that has been performed:

> It is my view that at any meeting where the remuneration is to be considered retrospectively, that the notice of that remuneration should include the calculation of that remuneration and a detailed description of the work performed for the period.[13]

7.20 A number of submissions expressed views about the timeliness of disclosure of the basis of remuneration. The Tax Office commented:

> It appears to be the common practice for administrators to table their work in progress reports at meetings of creditors and then seek creditors' approval of the fees incurred for work performed up to the date of the meeting. The Tax Office is of the view that it is unreasonable to expect creditors to cast an informed vote on a resolution to approve the fees unless they have been given a prior opportunity to properly consider the work in progress report. The Tax Office is of the view that administrators should be required to provide all known creditors with a summary of the work in progress report concurrent with the notice of the meeting at which they will be asked to approve the fees.[14]

7.21 The Committee agrees with the view that work in progress reports should be available to creditors before the meeting at which they will be asked to approve the fees. It believes that professional practice standards have the potential to enhance the level of disclosure of the basis for fees. In relation to disclosure, the IPAA Statement of Best Practice on Remuneration states that where remuneration is time based, creditors should be provided with details of the type of work to be undertaken by the appointee and the firm's staff, the estimated breakdown of the broad activity phases, the relevant experience of each person, the number of hours charged by each person,

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13 *Submission* 33, p. 8.

14 *Submission* 14, p. 5; See also *Submission* 49, p. 5. and *Submission* 53, p. 5.

the hourly rate charged for each person, the total remuneration claimed and the basis of recovering disbursements.

7.22 The Committee is concerned by the lack of detail as to the nature of work performed in work in progress reports as well as the timeliness of reports. It proposes that the IPAA review these two aspects of remuneration charging in its practice statement.

Recommendation 24

7.23 The Committee recommends that ASIC work with the professional bodies to encourage the promotion of best practice standards in remuneration charging and in particular the provision of adequate disclosure of the basis of fees charged by insolvency practitioners and on a more timely basis.

Administrator's casting vote in relation to his/her remuneration

7.24 The IPAA indicated that it was 'supportive of a change which would prevent an administrator using a casting vote in a resolution in which he or she has a direct interest'. A similar recommendation was made in Chapter 3 in relation to the use of a casting vote in relation to a resolution concerning the administrator's removal. For the same reasons, the Committee considers that it is inappropriate for an administrator to use a casting vote where the administrator has a direct personal interest in the outcome. It agrees that it is inappropriate for a casting vote to be used in relation to any resolution concerning the administrator's remuneration.

Recommendation 25

7.25 The Committee recommends that an administrator should be prohibited from using a casting vote in a resolution concerning his or her remuneration (see also recommendation 3).

7.26 The Committee considers that in light of concerns about the impact on competition, a scale of maximum fees is inappropriate. It is not convinced that fees should be regulated but believes that enhanced disclosure of the basis of fee setting can address some of the concerns expressed by creditors. The market should be allowed to determine the most efficient and cost-effective fee setting mechanisms. Nonetheless, it is of the view that unsophisticated creditors should have the capacity to negotiate meaningfully with practitioners about fees levied for external administrations. In the previous chapter, the Committee identified a need for creditors to be aware of the circumstances surrounding the failure of a company so they are better able to safeguard their interests. The same reasoning applies to understanding the fees and charges of insolvency practitioners.

Recommendation 26

7.27 The Committee recommends that ASIC, in consultation with the relevant professional bodies, implement appropriate means to educate unsecured creditors about the different methods of fee setting available and the rights which creditors have with regard to the setting of fees (see also recommendations 22 and 50).

Recommendation 27

7.28 The Committee recommends that ASIC periodically sample the fees charged by insolvency practitioners and make public a comparative report.

Cost savings in the conduct of external administrations

7.29 There may be scope to reduce the costs of external administrations by reviewing some of the procedural requirements of insolvency laws and making greater use of technological innovations in communications with creditors. Two submissions adverted to these possibilities.

7.30 The Law Council considered that there could be some savings in the cost of administrations by streamlining some reporting requirements and the amount of material that is required to be sent in hardcopy form to creditors. The requirements should be made more flexible so that information can be sent by email or in an abbreviated form and available for inspection.[15]

7.31 The ABA also considered that there was scope for cost savings:

> Notice requirements under the Act and the need for an administrator to apply to the court for leave to give required notices more efficiently and at much less cost indicate scope for streamlining the Act to reduce the cost of these administrations. Options such as were sought in the Ansett administration should be considered for inclusion in the Act as authorised means for these requirements to be met. They include use of websites, provision of material on request electronically and newspaper advertisements for some notices and information material.[16]

7.32 The Committee recommended in chapter 6 that the Government consider alternatives to the current advertising and gazettal requirements for external administrations and consider making technology and e-commerce options more widely available to help reduce the costs of external administrations. It also recommended that the provisions of Chapter 5 of the Corporations Act, be reviewed to permit alternative methods of conducting minor procedural meetings. These recommendations have the potential to reduce the cost of external administrations. The Committee considers that its recommendations in chapter 3 to allow other

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15 *Submission* 26, p. 14.

16 *Submission* 28A, p. 14.

professionals to conduct external administrations and to abolish the dual classification of official and registered liquidators also have the potential to encourage greater competition in the provision of insolvency services and reduce the costs of external administrations.

Receiver's remuneration

7.33 CPA Australia expressed concern about a number of aspects of receivers' remuneration. They included the lack of accountability by receivers for their fees; the absence of appropriate process for approval of receivers' fees; and the need for a mechanism whereby those fees may be scrutinised by ordinary unsecured creditors or the courts.[17] CPA Australia stated that when a receiver is appointed by a secured creditor his remuneration is subject to approval only by his secured creditor. There appears to be no requirement that receivers perform their duties efficiently and that they account for the time they spend on performing their tasks.

7.34 CPA Australia commented:

> There is currently a perception that receivers assume no responsibility at all to unsecured creditors or shareholders for their actions or for their charges. Unsecured creditors have no control over the assets and charges for the receivers and a perception is that once a receiver is appointed, ordinary unsecured creditors can presume that there will be nothing left over for anyone else, even if there should be once the necessary assets have been realised to satisfy the secured debt.[18]

7.35 The Committee notes that a review process in relation to remuneration payable to receivers is provided for under the Corporations Act. Fees charged by privately appointed receivers are determined by negotiation between the receiver and the appointing party. However, the court retains wide powers under s 425 to set and vary the remuneration of receivers. Under that provision applications for orders to fix a receiver's remuneration or vary it may be made by a liquidator, administrator, deed administrator or ASIC. One possible approach to the issue is to amend s 425 to empower a court in setting receivers' remuneration to take into account the cost of an associated winding up. The Committee draws these concerns to the attention of the Treasury Department.

Assetless administrations

7.36 A further issue relating to the cost of external administrations concerns the problem of remuneration of external administrators who conduct administrations of companies that have little or no assets available to pay for the administration. The remuneration and expenses of liquidators are ordinarily funded from the assets of the company in liquidation. A difficulty is created when the company has insufficient

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17 *Submission* 23A, p. 4.

18 *Submission* 23A, p. 4.

assets to cover these expenses. Creditors may indemnify a liquidator for expenses incurred but are unlikely to do so where the prospect of recovery is slight. Liquidators have no incentive to conduct such administrations. The Corporations Act provides that a liquidator is not under an obligation to incur any expense unless there is sufficient available property. In many cases no administration is conducted where insolvent assetless companies are involved. The company will simply be deregistered.

7.37 Many submissions were troubled by this issue. CPA Australia described the problem as follows:

> One of the primary functions of a liquidator is to investigate the financial affairs of the company and to examine the conduct of its officers and to report to ASIC as appropriate under s 533. There are many instances where the report and examination is constrained because the company is bereft of funds. Creditors show little or no interest in financing the pursuit of matters such as the possible recovery of preferences or examination of company officers to determine possible actions under Part 5.7B.[19]

7.38 In a supplementary submission, CPA Australia commented:

> Where a company has no assets it is more difficult to find a practitioner willing to act. Even if one is found the practitioner is likely to perform minimal tasks in order to achieve early finalisation. Under s. 545, with the exception of statutory reports, a liquidator is not compelled to incur any expense in the winding up of a company. In effect it is possible for rogue directors to strip a company of its assets (by phoenix type operations or other means) before taking steps to have it wound up and, in this way, ensure that minimal investigation and recovery action is likely to be undertaken.[20]

7.39 Mr Kerr referred to the Harmer Report which recommended the establishment of an assetless companies fund. He told the Committee:

> …Companies the subject of court originated liquidations are commonly assetless. Liquidators appointed to these administrations endeavour to

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19 *Submission* 23, p. 16.

20 *Submission* 23A, p. 5. Section 545 reads:

(1) Subject to this section, a liquidator is not liable to incur any expense in relation to the winding up of a company unless there is sufficient available property.

(2) The Court or ASIC may, on the application of a creditor or a contributory, direct a liquidator to incur a particular expense on condition that the creditor or contributory indemnifies the liquidator in respect of the recovery of the amount expended and, if the Court or ASIC so directs, gives such security to secure the amount of the indemnity as the Court or ASIC thinks reasonable.

(3) Nothing in this section is taken to relieve a liquidator of any obligation to lodge a document (including a report) with ASIC under any provision of this Act by reason only that he or she would be required to incur expense in order to perform that obligation.

> minimise the costs incurred and rely on section 545 of the Act to undertake minimal work on the administration. The major originators of Court appointments are now Workers Compensation Insurers and the Australian Taxation Office. The establishment of an assetless companies fund to pay insolvency practitioners to undertake a minimum level of investigation would in my opinion encourage better corporate conduct.[21]

7.40 The IPAA saw the problem of assetless companies as being closely related to that of phoenix companies. It stated:

> …the continuing problem of phoenix companies will only be properly addressed when funding is provided to enable liquidators to properly investigate and examine assetless companies and their officers.[22]

7.41 There are sound reasons for ensuring that assetless companies undergo some form of administration. Otherwise there is no mechanism for detecting and possibly curbing the reoccurrence of breaches of the law. For example, in anticipation of the formal commencement of insolvency proceedings, it is possible that unscrupulous directors may attempt to hide assets from their creditors, favour certain creditors over others, incur artificial liabilities, make gifts to relatives or friends or transfer the business and assets to another company set up for that purpose. Such transactions would be unfair to the company's unsecured creditors. If the company leaves insufficient assets to pay for an administration and no liquidator is able to carry out an administration, there is the strong likelihood that these transactions will not be investigated or payments not recovered for the benefit of creditors.

7.42 These circumstances potentially leave an avenue for abuse. More sophisticated phoenix type schemes are conceivable. A company can be set up in Australia to incur debts on a large scale with the proceeds of creditors' funds being sent overseas. The cost and complexity of overseas inquiries poses even greater obstacles to liquidators.

7.43 The Committee considers that the question of assetless administrations is one of the more difficult, longstanding and important issues that it has had to consider. No easy solution to the problem of assetless administrations presents itself, although a number of thoughtful solutions have been put forward.

7.44 The Harmer Report considered the creation of a centralised fund to which a wide class of persons could potentially contribute. The sources of funds might include payments by directors of companies being wound up, increased filing fees for winding up applications, interest on moneys realised from administrations and deposited in a common account, interest on trust accounts of practitioners and using monies and dividends unclaimed by creditors in liquidations. It recommended that a fund be created by a levy on all companies, payable annually at the time of filing a company's

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21 *Submission* 6, p. 11. See footnote 19 above.

22 *Submission* 22A, p. 13.

annual return.[23] The former Trade Practices Commission in its Report on the Accounting Profession also proposed the establishment of a fund to finance administrations of assetless companies.

7.45 The 1997 *Review of the Regulation of Corporate Insolvency Practitioners* examined the issue further, focusing in particular on the possibility of an assetless administration fund. It recommended the establishment of such a fund along the lines recommended by the Harmer Report to finance preliminary investigations of breaches of directors' duties and fraudulent conduct and that the ASC guide practitioners as to the contents of investigation reports.

7.46 Submissions supported this concept of a fund and the use of private sector practitioners to perform the work. Jones Condon commented:

> The government should pay liquidators a standard fee to do [official liquidations] thereby avoiding massive cross-subsidisation from funding. This could be potentially funded by a 'bond' imposed by ASIC when registering a 'new' company. If a company goes into liquidation the bond is paid to the liquidator. This would mean a Liquidator would get some funds if only minimal. If the company is deregistered with no liabilities then the bond is returned to shareholders.[24]

7.47 Issues that arise from the concept of an assetless administration fund include the problem of ensuring adequate accountability for the use of taxpayer funds, the administration, supervision and coordination of an assetless companies' program, the incidence of any levy and the definition of 'assetless company'.

7.48 The Committee considers that the problem of assetless administrations is an example of a market failure, giving rise to problems that call for an appropriate regulatory solution in the public interest. An alternative option for addressing this market failure is the creation of a public office in ASIC similar to that of the Insolvency Service in the UK. This Service undertakes, in every winding up order, the initial investigation into a company's failure, the causes of failure and generally the promotion, formation, business dealings and affairs of the company and makes its report to the court. If assets are available to fund the administration a private practitioner is appointed. This suggestion was rejected by the Harmer Report which preferred to use the skills of private practitioners to investigate assetless companies.[25]

7.49 The Committee considers that the establishment of an assetless administration fund along the lines recommended by the Harmer Report and supervised by ASIC is a more cost effective and efficient mechanism than the establishment of a new government agency or division within ASIC along the lines of the UK Insolvency Service. It makes no new demands on government resources and ASIC is well placed

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23 ALRC Report No 45, Vol 1, para. 349.

24 *Submission* 12, p. 8.

25 ALRC Report No 45, Vol 1, para. 345.

to supervise such a fund and coordinate and administer an assetless companies' program. It has continuous, close relations with insolvency practitioners both directly and through the Insolvency Practitioners Association of Australia and insolvency practitioners' foundation associations. An assetless administration fund could make effective use of the existing skills of insolvency practitioners.

Recommendation 28

7.50 The Committee is of the firm belief that the problem of assetless companies must be addressed. It recommends that the Government establish an assetless company administration fund to finance preliminary investigations of breaches of directors' duties and fraudulent conduct using the skills of registered insolvency practitioners.

7.51 The Committee makes no specific recommendation about how funding should be provided. It notes that the Harmer Report proposed a levy on all companies payable annually at the time of filing a company's annual return. The 1997 Report on the Regulation of Insolvency Practitioners supported the Harmer Report's proposal. An alternative would be to fund the scheme out of ASIC's existing income stream. This and other proposals are worthy of further consideration.

Empirical research into assetless companies

7.52 There is limited empirical data available on the incidence or the effects of assetless companies and the extent of strategic as opposed to real or involuntary insolvencies. Among some sectors there is a firm conviction that the incidence of companies taking deliberate actions to avoid paying creditors, especially employees, their entitlements is significant. The AMWU suggested that company directors use elaborate structures 'to allow them to restructure, seek loans, avoid workers' compensation insurance liabilities or make other corporate decisions by deliberately off loading parts of their company, while maintaining the parent intact'.

7.53 It submitted:

> These are often called 'phoenix' companies, which deliberately collapse and then re-establish themselves. This is common in the construction industry, where companies collapse at Christmas time, when there is not much work and so avoid liability for annual leave etc. and then re-establish when the industry is profitable again.[26]

7.54 In a recent survey of the impact of strategic insolvency on employees, Dr David Noakes concluded that the number of deliberate transactions to avoid employee entitlements were minimal compared to the overall number of insolvencies.[27] Whatever the statistics tell, and even if the loss of employee entitlements as a result of

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26 *Submission* 45, p. 5.

27 Noakes, Dr David, *Measuring the impact of strategic insolvency on employees*, (2003) 11 ILJ 91.

strategic insolvency may be a small aspect of insolvencies in Australia, it is of concern to the Committee.

7.55 ASIC analysis of the 6,176 statutory reports from external administrators in 2002-03 provides limited information about the incidence and impact of assetless companies. The Committee considers that, as a first step towards obtaining a better understanding of this longstanding issue and a sounder basis for choosing the most efficient form of any regulatory response, the nature and extent of the incidence and effects of insolvent assetless companies should be the subject of a commissioned study.

Recommendation 29

7.56 The Committee recommends that, as a step towards a better understanding of the nature, effects and extent of insolvent assetless companies, the Government should commission an empirical study of assetless companies.

Recommendation 30

7.57 The Committee further recommends that as a first and immediate step, ASIC begin to collate statistics on insolvent assetless companies and publish such figures on a triennial basis together with an analysis.

7.58 This chapter has considered mechanisms for determining fees charged by insolvency practitioners and the rights of creditors in the determination of fees. It has also considered the issue of remunerating practitioners for the conduct of administrations where there are scant resources available to fund the administration. This chapter has noted that the problem of phoenix companies is part of the broader issue of assetless companies. The following chapter examines in greater depth the impact of illicit phoenix schemes and possible measures for their prevention.

CHAPTER 8

PHOENIX COMPANIES

Fraudulent phoenix company schemes

8.1 Fraudulent phoenix company arrangements essentially constitute schemes which have the deliberate intent to defraud unsecured creditors and State and Commonwealth taxation authorities. Such schemes represent a serious abuse of the corporate form and the privilege of limited liability. This chapter considers the law's treatment of phoenix companies.

What is a phoenix company?

8.2 While the term 'phoenix company' is widely used in the corporate world, it is almost impossible to define fraudulent phoenix company activity with any precision. Drawing on earlier studies of phoenix company activity, the Cole Royal Commission defined phoenix activities in the following manner.[1] Phoenix activity occurs where an incorporated entity fails and is unable to pay its debts or acts with the intention to deny unsecured creditors equal access to the entity's assets in order to meet unpaid debts. Within 12 months another business commences, which may use some or all of the assets of the former business and is controlled by the directors or controllers of the previous entity or parties related to the directors or controllers.[2]

8.3 Phoenix company activity is not inherently unlawful. Business failure is not an offence. Nor is it an offence to fail on more than one occasion. If a company is placed into external administration and its assets are made available to creditors, it will not normally be improper or unlawful for the officers of that company to form a new company conducting a similar business. Nor will it be unlawful for the company's officers to purchase the assets of the old company from the administrator for use in a subsequent business.

8.4 The concept of limited liability is predicated on the assumption that, when a company fails, directors and shareholders are not ordinarily liable for the company's debts. Government policies throughout most of the world place a high value on the virtues of entrepreneurship and risk taking, which are generally perceived as necessary components of wealth creation in market economies. It is normal for companies to fail and be replaced by more successful ones.

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1 Volume 8, Reform – National Issues Part 2, Chapter 12 Phoenix Companies, p. 115.

2 This definition draws on the definition adopted by ASIC in its 1996 Report. See ASIC Submission to the Royal Commission into the Building and Construction Industry Regarding Phoenix Company Activity, 25 June 2002.

8.5 ASIC's submission to the Cole Royal Commission conveniently analyses the phenomenon in terms of 'Innocent phoenix operators', 'Occupational hazard' and 'Careerist offenders'. In the first case, an innocent phoenix operation commonly arises where a business gets into a position of financial stress that may be due to a combination of poor business practices, inadequate record keeping, cash flow management techniques, credit management failures or overly rapid expansion. The business owners apprehend that the business is unable to continue and place the company into external administration. Assets owned by the business will be made available to creditors in compliance with the law. They may then set up another business. In some cases the assets of the former business will be transferred to the new business. This may not necessarily be improper or a contravention of the law.

8.6 The Cole Commission commenting on this scenario noted:

> In the case of many high risk businesses, specialist equipment, other assets and even the business itself are largely unsaleable and the business has failed, consequently a liquidator appointed to such a business will often end up disposing of assets of the failed company to directors of the company who hope to resurrect the business with reserved personal finances.[3]

8.7 Of more serious concern are careerist offenders who purposely structure their operations in order to engage in phoenix activity, avoid detection and exploit loopholes in insolvency laws. Certain creditors are targeted: the ATO, State payroll and workers compensation premium authorities and employees owed entitlements such as superannuation and long service leave. The timing of implementation of the arrangements is leveraged to ensure the maximum amount of debt is accumulated in the old company. The new phoenix company is established at the last possible moment. Assets are transferred to it for no consideration or at a value significantly below the market cost of the assets in question. The new company has the potential to repeat the pattern of failure, with similar consequences for employees with outstanding entitlements, subcontractors and the ATO and State and Territory revenue bodies.

8.8 Deloitte Touche Tohmatsu considered that a difficulty with phoenix companies was that there are so many ways for control to be exercised by past directors over companies through spouses, relatives and friends and that there is a 'fine line between control and giving advice as an employee'.[4]

8.9 The Construction Forestry Mining and Energy Union (CFMEU) noted three common forms of phoenix company abuse in the construction industry. Under one form, a company will trade for a short period of time (typically between six months and two years), build up large debts (often to the Australian Taxation Office, the Office of State Revenue and WorkCover), go into liquidation and then another

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3 Volume 8, Reform – National Issues Part 2, Chapter 12 Phoenix Companies, para. 23.

4 *Submission* 19, p. 5.

company (often with a similar name) will take over all of its predecessor's operations. Under another form, a management company will own the assets and equipment used to run the business. A separate phoenix company will operate the business and employ the workers but have no assets. Group tax and GST will be under-remitted or not remitted at all and the phoenix company will be liquidated and replaced by another. The management company will continue to trade. The trust behind the management company may be a family trust.

8.10 A third more sophisticated form will involve a management company, a sales company and a labour hire company. The sales company receives all the income from the activities of the overall business. This company will then hire equipment and/or premises from the management company that holds all the assets. The sales company will also pay the labour hire company that employs all the workers, but only enough to pay its net wages plus an additional amount for workers entitlements.

8.11 The CFMEU commented:

> Little or no provision will be made for group tax and/or workers compensation payments. Sometimes the labour hire companies will not even have bank accounts and are just a façade which issues ATO Group Certificates or payment summaries, with the sales company directly paying the workers' wages. In all cases the labour hire company goes into liquidation leaving the management and sales companies to carry on.[5]

8.12 Empirical evidence as to the scope, incidence and impact of phoenix company activity is difficult to obtain or estimate.

8.13 The Cole Royal Commission found there had been significant incidence of fraudulent phoenix company activity in the building and construction industry particularly in the eastern states.[6] Earlier research carried out by the ASC in 1996 indicated that:

- annual losses to the Australian economy due to phoenix type activities were estimated to be in the range of $670 million to $1.3 billion (for the 2003 financial year these figures translate to a range of $1.04 billion to $2.4 billion);
- 18% of SMEs had experienced phoenix activities;
- 45% of phoenix activities appeared to be in the building and construction industry;
- 77% of phoenix companies will not have adequate books and records;

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5 *Submission* 56, p. 2.

6 Volume 8, Reform – National Issues Part 2, Chapter 12 Phoenix Companies, p. 161.

- 77% will transfer corporate assets to evade paying creditors; and
- the average phoenix company group generated creditor losses of about $557,000 which equated roughly to $90,000 per phoenix company group per annum over the average lifespan. The average number of creditors affected by a phoenix company group, again over its lifespan, appeared to be around 838 who lose on average $10,300 each.[7]

Investigations of phoenix company activity

8.14 Phoenix company schemes have been a longstanding concern of regulatory agencies, parliamentary committees and other bodies of inquiry. In 1992-93, the ASC launched a surveillance program targeting directors who had been repeatedly involved in company failures.[8] The Law Reform Committee of the Parliament of Victoria commenced an examination of the phoenix company phenomenon in 1993 and recommended changes to the Corporations Law to deal with the issue. The predecessor to this Committee, the Parliamentary Joint Statutory Committee on Corporations and Securities (PJCCS), expressed concern about abuses of the corporate form (i.e. phoenix company activity) in its 1994 and 1995 *Reports on the Annual Reports of the Australian Securities Commission and Other Bodies*.[9]

8.15 The 1994 Report noted in relation to the textile industry arrangements that have their echo in phoenix schemes considered by the Cole Royal Commission in 2003:

> Businesses have been structured so that employees of the business have been employed by a company with limited assets while assets of the business are held by a separate company. If these businesses cease the company employing group employees have no assets with which to pay accumulated holiday pay, long service leave or redundancy payments and are placed in liquidation. Principals of the business retain control of its assets in a separate company where they are not accessible to employees or creditors.[10]

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7 ASC Research Paper, Phoenix Companies and Insolvent Trading, No 95/01, July 1996, pp. 12, 74.

8 ASC Annual Report 1992-93, p. 31.

9 Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on the Annual Reports of the Australian Securities Commission, the Companies and Securities Advisory Committee, the Companies Auditors and Liquidators Disciplinary Board and the Australian Accounting Standards Board 1992-1993*, June 1994, p. 6; and *Report on the Annual Reports of the Australian Securities Commission and Other Bodies: 1993-1994*, 23 October 1995, p. 10.

10 Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on the Annual Reports of the Australian Securities Commission, the Companies and Securities Advisory Committee, the Companies Auditors and Liquidators Disciplinary Board and the Australian Accounting Standards Board 1992-1993*, June 1994, p. 6.

8.16 In another initiative in June 1995, the ASC announced that it would target 'strings of companies' or 'phoenix' company chains in a Community Response Project. It emphasised that it would focus on directors who have a history of moving from company to company, leaving a trail of debts behind them. The Project sought to research the issues, and inform companies, accountants and industry associations how they could reduce the risk of harm from insolvent and phoenix companies.[11]

8.17 In August 1995, the then Attorney-General, Michael Lavarch, announced that the Corporations Law Simplification Task Force would examine this issue as part of Stage 3 of the Corporations Law Simplification Program.

8.18 In 1996-97, the ASC released research on insolvent trading and phoenix companies. It suggested that small businesses could protect themselves by researching companies and directors through its database and other credit checking organisations.[12] It began 122 investigations into alleged insolvent trading and phoenix company activity and took action in 73 matters including prosecution, civil penalties, banning directors or obtaining a resolution of the complaint. In the following 12-month period, ASC surveillance teams specifically targeted insolvent trading and apparent phoenix company activity inspecting over 200 companies. It implemented various remedies including prosecution, civil penalties, banning orders and warning letters to directors.[13]

8.19 More recently, both the ATO and ASIC have instituted programs to identify and pursue companies and individuals that engage in phoenix company activity. ASIC in particular has undertaken a number of initiatives in recent years to address the incidence of phoenix company activity. Project Westgate which ran from 1999 to 2000 involved identifying early indications of insolvency from various sources including credit reference agencies. It targeted both insolvent trading and phoenix company activity. Legislative amendments to the director disqualification provisions were made by the Coalition Government in the Corporate Law Economic Reform Act 1999.[14]

8.20 The most recent examination of the phoenix company problem has been undertaken by the *Cole Royal Commission into the Building and Construction Industry,* which reported in February 2003.[15]

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11 ASC Annual Report 1995-96, p. 21.

12 ASC Annual Report 1996-97, p. 22.

13 ASC Annual Report 1997-98, p. 32.

14 Act No 156, 1999. The provisions took effect from 13 March 2000.

15 See *Final Report of the Royal Commission into the Building and Construction Industry*, February 2003: Volume 8, Reform – National Issues Part 2: Chapter 11 Payroll Tax Obligations – Non-compliance, Chapter 12 Phoenix Companies; Volume 9, Reform – National Issues Part 3: Chapter 16 Taxation Obligations – Evasion.

8.21 The incidence of phoenix company activity is difficult to estimate. In a submission to the Cole Royal Commission, ASIC expressed concern about allegations of phoenix company activity that relied heavily on anecdotal evidence without an appropriate level of underlying statistical support or analysis.[16] It agreed that unlawful phoenix activity was a serious matter but noted that, on its statistics, only 0.7% of all complaints and reports of information received in the 2001-2002 financial year could be identified as relating to phoenix company activities. Of these reports, ASIC notes that 6% related to the building and construction industry with 94% being related to industries other than that particular industry.

8.22 These findings underline the fact that phoenix strategies are not peculiar to one or two industries but can be a feature of many industries. A number of submissions noted this point. Mr Kerr stated that though the use of phoenix companies in the building and construction industries has been widely reported, their use is found in most industries.[17] The ACTU expressed a similar sentiment:

> The use of phoenix companies to avoid payment of award or agreement obligations to employees (along with tax, workers' compensation and other debts) is common in a number of industries, including building, clothing and meat.[18]

Anti-phoenix initiatives

8.23 There are different methods of dealing with phoenix activities and directors of phoenix companies who deliberately seek to abuse the corporate form. Unlawful phoenix activity will often involve a breach of one or more of the general duties of directors, in particular the duty of good faith and duties concerning proper use of information or position. Unlawful phoenix activity may also be likely to involve voidable transactions or constitute a contravention of the insolvent trading provisions or the newly introduced provisions of Part 5.8A aimed at protecting employee entitlements (see paragraphs 8.93 and 10.56–10.67).

8.24 The main legislative approach dealing with phoenix company activity has not been to define phoenix activity as such but rather to provide for disqualification of directors in certain circumstances and set penalties for contravening the disqualification.

Disqualification of directors

8.25 The current provisions of the Corporations Act dealing with the disqualification of directors from managing corporations are set out in Part 2D.6,

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16 ASIC response to and comments on Final Submission of Counsel Assisting concerning Phoenix Companies, 20 December 2002.

17 *Submission* 6, p. 12.

18 *Submission* 32, p. 13.

which was introduced by the *Corporate Law Economic Reform Act 1999*. Part 2D.6 essentially reorganised and brought together the former Corporations Law director disqualification provisions. Though the wording of the provisions differs in some respects from the former provisions, it does not introduce substantial changes. The provisions have in essence remained unchanged since the commencement of the previous national companies' scheme.

8.26 The scheme of Part 2D.6 is that s 206A prohibits disqualified persons from managing corporations and ss 206B-F specify various grounds on which a person may be disqualified from managing a corporation. They include:

- bankruptcy related grounds;
- repeated contraventions of the Corporations Act;
- involvement with failed corporations;
- conviction for certain offences; and
- contravention of a civil penalty provision.

8.27 The provisions provide for automatic disqualification (s 206B), disqualification by a Court (ss 206C, 206D and 206E) and disqualification by ASIC (s 206F).

8.28 Section 206B automatically disqualifies a person from managing corporations if he/she is convicted on indictment of an offence concerning the business or financial standing of the corporation, or is convicted of an offence under the Corporations Act carrying a prison term greater that 12 months, or an offence involving dishonesty and a prison term of at least three months. The period of disqualification is five years. It also disqualifies a person who is an undischarged bankrupt or who has executed a deed of arrangement or whose creditors have accepted a composition under Part X of the Bankruptcy Act. [19]

8.29 Section 206C permits ASIC to apply to a court for a disqualification order for a period the court considers appropriate where a declaration has been made under s 1317E that the person has contravened a civil penalty provision and the Court is satisfied that the disqualification is justified.

8.30 Section 206D permits ASIC to apply to a court for an order prohibiting a person from managing a corporation for up to 10 years where the person has been an officer of two or more corporations that have failed. The court must be satisfied that

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19 *CLERP (Audit Reform & Corporate Disclosure) Bill, Commentary on the Draft Provisions,* Corporate Law Economic Reform Program No. 9, October 2003, p. 98. The Bill inserts section 206BA which would allow Courts to disqualify persons for up to a further 15 years on application by ASIC. The application must be made within the first year of the automatic disqualification.

the person was, within a seven year period, a director of the failed corporations and the manner in which their affairs had been managed was wholly or partly responsible for the company being placed into administration or ceasing to carry on business and the disqualification was justified.[20]

8.31 Section 206E allows ASIC to apply to a court to disqualify a person from managing corporations for a period the court considers appropriate where there have been repeated contraventions of the Act. ASIC must satisfy the court that the person has been an officer of a body corporate and failed to take reasonable steps to prevent the contravention on two or more occasions or had at least twice contravened the Corporations Act while an officer of the body corporate, or failed to exercise a reasonable degree of care and diligence under s 180 or good faith under s 181. Also the court must be satisfied that the disqualification is justified.

8.32 Section 206F empowers ASIC to disqualify persons from managing corporations. ASIC may disqualify, for a period of up to 5 years, persons who have managed two or more corporations within a 7 year period which have been wound up and the liquidator had lodged reports under s 533(1) on the corporations' inability to pay their unsecured creditors. The winding up must take place while the person was, or within 12 months of ceasing to be, an officer of the corporation. Under s 533(1) a liquidator must lodge a report with ASIC if it appears that an officer has been guilty of an offence, a person involved in the company's management has been negligent or breached a duty to the company, or the company may be unable to pay its unsecured creditors more that 50 cents in the dollar.

8.33 ASIC must be satisfied that the disqualification is justified. It must also give the person a notice requiring him/her to demonstrate why he/she should not be disqualified and an opportunity to be heard on the question. In determining whether disqualification is justified ASIC must have regard to the person's conduct in relation to the management, business or property of any corporation, whether the disqualification would be in the public interest and any other matters ASIC considers appropriate.

8.34 ASIC is required under s 1274AA to keep a register of persons who have been disqualified. It may grant a disqualified person permission to manage a particular corporation or corporations and may do so subject to conditions and exceptions.[21]

8.35 While the Committee did not receive any submissions which examined the problem of phoenix companies in depth, many submissions commented on the nature

20 *CLERP (Audit Reform & Corporate Disclosure) Bill, Commentary on the Draft Provisions,* Corporate Law Economic Reform Program No. 9, October 2003, p. 98. The Bill increases the maximum period of disqualification to 20 years.

21 *CLERP (Audit Reform & Corporate Disclosure) Bill, Commentary on the Draft Provisions,* Corporate Law Economic Reform Program No. 9, October 2003, p. 98. The Bill also proposes to clarify the contents required in ASIC's register of disqualified company directors and other officers.

and incidence of illicit phoenix company activity. Almost all regarded the problem as a serious one requiring the attention of the legislature and were supportive of strengthening measures against phoenix companies.[22] For example, the Tax Office questioned whether the legislation governing voidable preferences, insolvent trading and fraud was sufficient to counter phoenix type activity.[23]

8.36 Indeed, a number of witnesses were highly critical of current provisions. Mr Robert Charles, ATO, was one who claimed that the existing disqualification regime was not working. He said:

> We say that on the basis that we see instances of the same directors managing companies into the future without being disqualified, and we believe the system may be improved with increased clarity in terms of the consequences of being directors of insolvent companies.[24]

8.37 The following section considers three approaches to the deterrence and prevention of phoenix company activities: increased sanctions, improved means for detecting phoenix company activities and measures to ensure the adequate investigation of failed companies and the prosecution of offenders.

Increased sanctions

8.38 Many submissions commented on the need for appropriate sanctions for illicit phoenix company activity. Jones Condon proposed that directors be automatically banned for a period of three years from being a director or managing a company if they have had three or more failed companies and, where they have a history of corporate failures, should be required to pay a bond of $10,000 when a new company is created. It also suggested that trade or professional licences of directors who indulge in phoenix company activity should be cancelled and directors be personally liable for debts if they engage in phoenix activity. Family members should be restricted in incorporating companies that perform the same business.[25]

8.39 The AMWU considered that in the case of a company collapse, there should be a reverse onus of proof for company directors to prove to an ASIC inquiry that they had fulfilled all of their fiduciary duties, before they are permitted to hold any positions as a company director or officer.[26] Mr Paul Bastian, AMWU, told the Committee:

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22 *Submission* 12, p. 8; *Submission* 14, p. 8; *Submission* 19, p. 5; *Submission* 23A, p. 6; *Submission* 26, p. 17; *Submission* 28A, p. 16; *Submission* 32, p. 14; *Submission* 33, p. 10; *Submission* 45, Schedule A, p. 15; *Submission* 48, p. 6.

23 *Submission* 14, p. 8.

24 *Committee Hansard*, 26 June 2003, p. 53.

25 *Submission* 12, p. 8.

26 *Submission* 45, p. 15.

> From our experience, in non-construction, the issue with phoenix companies is the reverse onus issue—to bar them. A phoenix company is normally an example of where the director has been involved in some activity to allow the dead limb to be severed and dropped deliberately. A good example may be an industrial accident where a worker has died and they are going to receive a heavy fine. They cut their losses and start up again. That is an example where you would want to have a reverse onus, so that they would have to demonstrate their bona fides to a proper authority, like ASIC, who can then make a proper judgment about whether or not they have discharged their onus in accordance with law; if they have not, they are out. As it currently stands, our estimate is that 98 per cent of them run the gauntlet.[27]

8.40 QBE Insurance Ltd advocated much stronger legislative measures regarding fraudulent phoenix companies, including an immediate ban from acting as a director for a period of time immediately following involvement in any insolvency that does not provide a return to all creditors of at least 50 cents in the dollar. It also noted that regulators need to enforce the law in situations where bankrupts are not eligible to continue as company directors. In its view:

> There are numerous cases currently where the regulators have continued to allow bankrupts to be company officers and directors.[28]

8.41 The CPA also made the following point:

> …there should be legislative prohibition of the use of phoenix companies, together with severe penalties unless the participants are able to show that the assets transferred have been independently valued and transactions completed at arms length. Further, the legislation should not allow transfer of assets to be funded by setting off of debts as this allows the purchasing entity to, in effect, receive a preference.[29]

8.42 In relation to the building and construction industry, the Cole Royal Commission recommended a range of additional measures to deter the incidence of fraudulent phoenix companies, in particular:

- an increase in the maximum penalties for offences associated with fraudulent phoenix company activity;[30] and
- an extension of ASIC's power of disqualification to permit disqualification where a person on one occasion was an officer of a corporation which has been wound up and been the subject of a liquidator's report.[31]

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27 *Committee Hansard*, 11 November 2003, p. 349.

28 *Submission* 49, p. 6.

29 *Submission* 23A, p. 6.

30 Recommendation 108.

31 Recommendation 109.

8.43 Although generally in support of the Cole recommendations, the Government rejected the recommendation to permit disqualification where a person on one occasion was an officer of a corporation which has been wound up and been the subject of a liquidator's report.[32]

8.44 In evidence to the Committee, this recommendation received a mixed reaction. Mr Peter Anderson, Australian Chamber of Commerce and Industry (ACCI), told the Committee that they generally supported the Cole Royal Commission's recommendations on phoenix companies. They had the most difficulty, however, with the recommendation that ASIC be entitled to take action to disbar a director if he or she had on only one occasion been a director of a company which had become insolvent. He submitted:

> Our view is that that is probably going too far. If the recommendation was linked to the core issue that Cole looked at, and that was fraudulent phoenix companies, then it may be a sustainable proposition. Our response to that one is that that particular recommendation is probably framed too broadly. If it was narrower, to the issue of a director who had been involved in fraudulent phoenix companies, then it is hard to see why ASIC would not have scope to take action in those circumstances to debar. But, generally speaking, a right to debar a person and take legal action simply because they had previously been a director of a company that had gone insolvent on one occasion seems to be, in broad, going a step too far. We have generally supported the other recommendations of Cole on phoenix companies.[33]

8.45 Mr Stephen Smith, Australian Industry Group, took a similar approach.

> …we believe that the royal commission's proposals have merit and that we support the idea in principle that laws should be changed in this area and toughened, given the evidence that was before the royal commission and the findings of the royal commission about phoenix companies. But we also made a strong point that you need to get the balance right because, if it is not struck at an appropriate level, it will have a negative impact on entrepreneurship and risk taking. It would be unfair to seriously disadvantage owners of businesses who legitimately put up their own capital and go broke, normally at great hardship to that individual. Everyone would agree, I think, that it needs to be struck at an appropriate level. In short, what we have said about those proposals is that we support the basket of them in principle but we believe they need to be looked at in great detail in drafting them into legislation.[34]

8.46 The Committee agrees that legislation seeking to minimise the potential for abuse, must take care not to stifle commercial enterprise.

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32 Government's response to the 212 recommendations of the Cole Royal Commission, Item 109, www.workplace.gov.au/building.

33 *Committee Hansard*, 7 August 2003, p. 72.

34 *Committee Hansard*, 8 August 2003, p. 149.

CLERP 9

8.47 The CLERP 9 Bill introduced into Parliament on 4 December 2003, is in part a response to recommendations on fraudulent phoenix company activity by the Cole Royal Commission. It proposes to increase the maximum period of court-ordered disqualification of directors for involvement in repeated company failures from 10 to 20 years; and to allow ASIC to apply for an additional period of disqualification (of up to a further 15 years) for persons who become automatically disqualified from managing a corporation.[35]

8.48 The majority of submissions to the Committee's inquiry into CLERP 9 that commented on this proposal supported the increased penalties. The Committee considered these proposals to increase penalties during its inquiry into CLERP 9.[36] Some suggested that stronger measures should be taken to ensure that people deemed unsuitable to manage a company are not permitted to do so. Other proposals included:

- the legislation to provide direction to the courts to ensure that a disqualified director is not in a position to manage the company in a de facto senior manager's role;[37]
- a longer period of disqualification due to 'the long term influence of the board and board members on a corporation's culture and operations'—the Australian Shareholder's Association suggested a life-time ban for a director found to 'have a cavalier attitude to the law';[38] and
- the provision to disqualify directors where they have failed to meet their liabilities (not just debts) including employee entitlements and superannuation contributions.[39]

8.49 The Centre for Corporate Governance, however, objected to the increase in the maximum period of disqualification to 20 years on the grounds that the 10-year period has only been in operation since March 2000 and there was no evidence justifying the increase. The Centre 'was unable to uncover a case in which s 206D had been used to impose the maximum penalty of 10 years' and hence in 'the absence of evidence of the need for doubling the maximum penalty suggests…that there is no

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35 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Schedule 4, Part 2, items 2-4.

36 Parliamentary Joint Committee on Corporations and Financial Services, *CLERP (Audit Reform and Corporate Disclosure) Bill 2003, Part 1: Enforcement, executive remuneration, continuous disclosure, shareholder participation and related matters,* pp. 201–3.

37 *Submission* 8,to Inquiry into CLERP 9, p. 7 of 15.

38 *Submission* 22 Inquiry into CLERP 9, p. 3.

39 *Submission* 38, Inquiry into CLERP 9 p. [8].

such need'.[40] It also opposed raising the maximum period under automatic disqualification clauses from 5 to 20 years.[41]

8.50 More generally, the AICD in evidence to this Committee was of the view that the current arrangements for ASIC to ban directors are appropriate and there is no need to formulate new laws to restrict incidents of fraudulent phoenix companies. It noted, however, that the laws 'require more robust enforcement by ASIC, particularly in relation to smaller companies where ASIC has appeared not to have focussed as readily'. It concluded:

> If greater resourcing for enforcement by ASIC is not possible perhaps there is a case for the legislature to provide for automatic disqualification if a person has been an officer of two or more failed unrelated companies within a set period eg three years. Directors should be given an opportunity to appeal where they consider that the application of such a rule would create an unjust result.[42]

8.51 Indeed, the director disqualification provisions, ss 206B-F, and in particular s 206F, appear to be seldom used.

Limitations of s 206D and s 206F

8.52 The Committee accepts that ss 206D and 206F may impose too many legislative hurdles and preconditions for their effective operation. Under s 206D, the person must have been, within a seven year period, a director of two failed corporations and the manner in which their affairs had been managed was wholly or partly responsible for the company being placed into administration or ceasing to carry on business and the disqualification was justified.

8.53 Section 206F is more detailed in its requirements. Under s 206F, ASIC may disqualify, for a period of up to 5 years, persons who have managed two or more corporations within a seven year period which have been wound up and the liquidator had lodged reports under s 533(1) on the corporations' inability to pay their unsecured creditors. The winding up must take place while the person was, or within 12 months of ceasing to be, an officer of the corporation.

8.54 It is arguable that s 206F limits the opportunities for ASIC to take sufficiently early action to deter the implementation of fraudulent phoenix company schemes. The Cole Report noted that the phoenix company problem arises where a company has no assets. It is possible that creditors may choose not to incur the expense of having a liquidator appointed to it. Instead the company is likely to be deregistered by ASIC without a formal liquidation. Section 206F does not appear to be triggered by such an

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40 *Submission* 21, pp. 16–17.

41 Centre for Corporate Governance, *Submission* 21, p. 16.

42 Additional Information, Mr Rob Elliott, National Policy Manager, AICD, 19 December 2003.

outcome. Conceivably two phoenix company schemes may be implemented before ASIC is permitted to act under the provision.

8.55 It appears that s 206F is a rarely used provision. In evidence provided in relation to its statutory oversight hearing, ASIC advised that it did not finalise any bannings under s 206F in the year to 30 June 2003. There were two bannings in July 2003 and another in August 2003.[43]

8.56 The Committee considers that ss 206D and 206F should not be subject to a requirement to have managed two or more failed corporations and within a certain period of time. It considers that ss 206D and 206F should be cast in simpler terms which permit the court, or ASIC in its discretion, to disqualify a person from being a director where essentially two conditions are met. They are: the person is or has been a director of a company which has failed (as defined in s 206D(2)); and the person's conduct as a director of that company (either taken alone or taken together with his/her conduct as a director of any other company) makes him or her unfit to be concerned in the management of the company.

8.57 The Committee emphasises that it in no way supports a 'one strike and you're out' principle. A market economy must encourage enterprise and a business culture that accepts risk taking and entrepreneurship. Company law must foster such values. It should be easy to adopt a corporate form for the conduct of a business. A person may be involved in several honest business failures without attracting the application of director disqualification provisions. The Committee's proposal is aimed at persons who act dishonestly or recklessly. It considers that ASIC or a court should have the capacity to consider whether the facts and circumstances of a person's conduct and involvement in relation to a particular company or in relation to two or more companies are serious enough overall to warrant a finding that a person should be disqualified from managing a company for a period of time.

8.58 The Committee considers that these amendments will broaden the circumstances in which ASIC may disqualify a person and allow persons who should not remain as directors to be removed or disqualified quickly. Of course, any amendment should allow persons appropriate appeal rights.

Recommendation 31

8.59 The Committee recommends that ss 206D and 206F should not be subject to a requirement to have managed two or more failed corporations. They should permit a court, or ASIC in its discretion, to disqualify a person from being a director where essentially two conditions are met: the person is or has been a director of a company which has failed (as defined in s 206D(2)) and the person, as a director of the company (either taken alone or taken together with his/her

43 Mark Drysdale, Executive Director, Public & Commercial Services, 25 November 2003.

conduct as a director of any other company) makes him or her unfit to be concerned in the management of a company.

Improved means of detection

8.60 The AICD was not alone in its observations that enforcement of the current legislation may be a problem (see paragraph 8.49). A key element of enforcement is the detection of wrongdoing and the effective prosecution of offenders. The following section looks at detection and prosecution of phoenix type activity.

8.61 The AMWU considered that there is currently little pursuit of directors who avoid paying employee entitlements due to a lack of ASIC funding. It noted:

> Criminals are keeping their businesses small so they fly below ASIC's radar.[44]

8.62 The Tax Office considered that identification of directors who have been office bearers of insolvent companies would assist.[45] The ABA considered that there would be a benefit to the business community if information about persons involved in multiple corporate failures were organised in a way, for example as a register, that is readily available to businesses as part of their business and credit risk decision making processes.[46]

8.63 In relation to the detection of phoenix company activities, the Cole Royal Commission recommended:

- guidelines to clarify the separate responsibilities of government agencies, particularly ASIC and the ATO, in combating fraudulent phoenix company activity (recommendation 104);
- legislation to permit the sharing of information between government agencies relating to such activity (recommendation 105);
- the implementation of measures to check all new company officers against the National Personal Insolvency Index and to check that current directors have not been declared bankrupt (recommendation 106); and
- checks to identify companies that are left without a director following the bankruptcy of a serving director (recommendation 107).

8.64 The Committee supports these recommendations. It agrees that the detection, investigation and prevention of illicit phoenix company activity cannot be the responsibility of one agency. It is desirable for State and Commonwealth Government

44 *Submission* 45, p. 10.

45 *Submission* 14, p. 8.

46 *Submission* 28A, p. 16.

agencies who have responsibility for the collection of revenue or levies and ASIC to consult on their respective interests, concerns and responsibilities in responding to phoenix company activities and coordinate their efforts including exchanging information.

8.65 The Committee supports the Cole Commission's recommendation that steps be taken to check all new company officers against the National Personal Insolvency Index and to check that current directors have not been declared bankrupt.

8.66 The Committee notes that in its detailed response to the Cole recommendations outlined above, the Government is broadly supportive of these initiatives.[47] In relation to legislation to permit the sharing of information between government agencies, the Government will form a working party comprising relevant parties to consider the issues. The Committee is satisfied with the Government's response to the above issues. In addition, the CLERP 9 Bill introduced into Parliament on 4 December 2003 proposes to expand and clarify the contents of ASIC's public register of banned and disqualified directors.[48] During its inquiry into CLERP 9, the Committee noted the proposed changes to the register of disqualified directors.[49]

8.67 The Committee notes a further related consideration, the cross checking of business names on State business names registers with company ACNs[50] and the ASCOT database.[51] Mr Drysdale, Executive Director, Public and Commercial Services, indicated that various mechanisms were available to be used to detect possible unlawful phoenix company activity. They included using the ASCOT database of company officers for checking against ITSA's National Personal Insolvency Index. Professor Collier noted that the same checks were not available against State Business Names Registers. Mr Drysdale commented:

> [U]p until the mid-nineties most of the state business names registers were either run or organised with ASIC. In particularly the larger states it has been taken back by the states and they run the registers themselves. If we are doing an investigation on the basis of one of the sources I spoke about earlier, checks of things like business names registers, the bankruptcy

47 See Table of the Government's Response to the 212 Recommendations of the Cole Royal Commission, www.workplace.gov.au/building.

48 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Schedule 4, Part 2, items 2-4.

49 Parliamentary Joint Committee on Corporations and Financial Services, *CLERP (Audit Reform and Corporate Disclosure) Bill 2003,* pp. 201–2 and 204.

50 Australian Company number.

51 ASCOT is ASIC's national corporate database and holds information on all Australian corporations, directors of companies, foreign companies, other registered bodies, futures brokers, futures advisers, securities and futures and futures representatives, banned persons and people holding financial services licences.

database—the MPII—are routine parts of the early stages of that investigation.[52]

8.68 The Committee considers that the business names of companies on State Business Names Registries should be available to be checked against the ASCOT database of company names and ACNs, as the absence of such a facility presents obstacles to the identification of companies engaging in unlawful phoenix activities.

Recommendation 32

8.69 The Committee recommends that the Government in association with the Council of Australian Governments review the adequacy of the arrangements for the checking of the business names of companies on State Business Names Registries against the ASCOT database of company names and ACNs.

Adequate investigation and prosecution of offenders

8.70 In the previous chapter, the Committee examined the remuneration and expenses of liquidators which are ordinarily funded from the assets of the company in liquidation. The Corporations Act provides that a liquidator is not under an obligation to incur any expense unless there is sufficient available property (see paragraph 7.36).[53] The Committee noted that if a company leaves insufficient assets to pay for an administration and no liquidator is able to carry out an administration, there is the strong likelihood that these transactions will not be investigated or payments not recovered for the benefit of creditors.

8.71 Typically with phoenix companies the old company will be left with no or minimal assets to fund an administrator's investigation into, or pursuit of, the company's former assets and business, making it unlikely that creditors will have a liquidator appointed to it. This point was reiterated in a number of submissions. For example, the IPAA expressed the view that:

> the continuing problem of phoenix companies will be properly addressed only when funding is made available to liquidators to properly investigate and examine assetless companies and their officers.[54]

8.72 The ACTU noted the recommendations of the Cole Royal Commission and stated that it supports any initiative to address this problem. In addition to increased penalties, it also commented:

> The recommendations relating to increased resources to the ATO and ASIC, and greater information sharing, need to be acted on without delay…The recommendations made [by the Cole Royal Commission], concerning

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52 *Committee Hansard*, 20 August 2003, p. 260.

53 Corporations Act, s 545.

54 *Submission* 22A, p. 13.

> directors' personal liability and pooling of assets between related companies for the purpose of meeting employee entitlements are also applicable to phoenix companies.[55]

8.73 The Committee considers that the evidence presented to it points to a clear connection between the problem of assetless companies and phoenix company schemes. The evidence underlines the importance of the Committee's recommendation made in the previous chapter concerning the need to establish an assetless administration fund to finance preliminary investigations by registered insolvency practitioners of breaches of directors' duties and fraudulent conduct. The assetless companies and phoenix company syndrome will only be addressed properly when a funding mechanism for the investigation and prosecution of offenders is instituted. The adequacy of ASIC's resources to act on reports and complaints as well as initiate its own investigations also came under question. In CPA Australia's view:

> There is a perception that the preponderance of phoenix companies is due, in part, to lack of prosecution by the ASIC for offences committed and in part, to lack of sufficient investigation by liquidators.[56]

8.74 Many other submissions commented adversely on the lack of follow up action taken by ASIC in relation to offences detailed in insolvency practitioners' reports. A number of those submissions attributed ASIC's inaction to a lack of adequate funding. Creditors affected by insolvencies also expressed concerns about insufficient action taken by ASIC in response to what they considered to be clear breaches of the law. In the following chapter on the reporting and consequences of suspected breaches of the Corporations Act, the Committee discusses ASIC's resources and assesses the action taken in relation to 6,176 statutory reports it received in 2002–03 and makes recommendations to address concerns raised.

Preventative action

8.75 The director disqualification provisions as a mechanism for deterring phoenix company activity suffer from one significant disadvantage. They may only be invoked after the impugned events have taken place and insolvency proceedings commenced. The damage has by definition already occurred. ASIC and its predecessor, the ASC, have initiated various strategies at different times which seek to anticipate and prevent unlawful phoenix activities.

8.76 In chapter 4, the Committee noted that the National Insolvent Trading (NIT) Program aims to make company directors aware of their company's financial position, to alert directors of potentially insolvent companies to their responsibilities and the implications of continued trading. The program is also intended to encourage directors to seek external advice from accountants and lawyers on restructuring possibilities, to

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55 *Submission* 32, p. 14.

56 *Submission* 23A, p. 6.

encourage directors to seek advice from insolvency professionals where appropriate and to take action to appoint a voluntary administrator or liquidator where necessary.

8.77 The program represents a valuable initiative in deterring phoenix company activities before they occur. The Committee supports such preventative strategies as a useful addition to ASIC's surveillance, investigation and enforcement activities, particularly in relation to unlawful phoenix companies.

8.78 The Committee notes that the Law Reform Committee of the Victorian Parliament in its 1994 *Report on Curbing the Phoenix Company* proposed a system for the preservation of corporate assets to prevent the transfer of such assets in the pursuance of unlawful phoenix company activity.[57] It recommended the introduction of a statutory process analogous to a Mareva injunction that would enable the courts to freeze a director's assets on which the corporation has a just claim.[58]

8.79 The Committee considers that this recommendation warrants further consideration.

8.80 The Cole Royal Commission has highlighted the need for a range of responses and mechanisms to respond to illicit phoenix company schemes. In the Committee's view, the Victorian Committee's suggestion has the potential to deter unlawful phoenix company activity by preventing the transfer of corporate assets to an associated company and support preventative initiatives such as ASIC's National Insolvent Trading Program.

Recommendation 33

8.81 The Committee recommends that the Government consider the proposal to create a statutory process analogous to a Mareva injunction to enable the courts to freeze assets of a director or manager which are prima facie assets on which the corporation has a just claim.

8.82 Another important preventative measure is to ensure that bogus companies are not established in the first place by ensuring that there are rigorous checks in place to establish the bona fides of those setting up companies. The CFMEU in its submission to the Senate Workplace Relations Building and Construction Inquiry asserted that the corporations law needs to be reformed to address the ease by which people can establish $2 companies. It maintained that 'Greater controls are needed for people wishing to establish a business'.

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57 Law Reform Committee of the Victorian Parliament, *Curbing the Phoenix Company: First Report* 1994, para. 4.1.44.

58 A Mareva injunction is an injunction designed to prevent a party from dissipating property or moving property or assets out of the jurisdiction.

8.83 The Committee agrees that tightening procedures for those wishing to establish a company is another area that should be targeted in the endeavour to stop fraudulent phoenix company activity.

Recommendation 34

8.84 The Committee recommends that the Government review the processes in place for registering a company with a view to improving the measures for determining the bona fides of those applying to register a company.

ASIC hot-line

8.85 The Committee notes that trade unions through their members have the ability to become aware of the possible incidence of phoenix activities at an early stage. The AMWU referred to a number of specific instances of phoenix activities in smaller companies of which it had become aware.[59] It seems only sensible for ASIC to facilitate the reporting of wrongdoing particularly from a sector that is well placed to have early knowledge of a company's shenanigans.

Recommendation 35

8.86 The Committee recommends that ASIC consider establishing a hot-line and guidelines for its operation in conjunction with strategically located employees for the purpose of facilitating possible early detection of, and intervention to prevent the implementation of, illicit phoenix activities.

Recovery of debts

8.87 Another aspect to phoenix company activity is the recovery of debts. The following section looks briefly at this matter.

Corporate group liability

8.88 A number of submissions proposed generally that other corporate group companies should be liable to contribute to the debts of insolvent group members. The Tax Office noted that the Payroll Tax Act (NSW) now includes grouping provisions to assist in the recovery of State tax debts that might otherwise be irrecoverable due to phoenix activities.[60] The AMWU expressed concern about the sanctity of the 'corporate veil' in corporate legal theory:

> The practical effect of the corporation being regarded at law as a separate legal entity is that company directors are able to separate assets from the corporation, so that when the corporation is placed into administration, the

59 *Submission* 45, Schedule A, p. 15.

60 *Submission* 14, p. 7; see also *Submission* 32, p. 14.

> assets are not accessible by employees and other creditors who have not been paid.[61]

8.89 The Cole Royal Commission examined the extent of non-compliance with payroll tax obligations in the building and construction industry.[62] It found that there was substantial evidence of non-compliance with payroll tax obligations in the building and construction industry.[63] It recommended that the Commonwealth encourage the States and Territories to consider the adoption of the provisions contained in s 16LA of the Pay-Roll Tax Act (NSW) to address phoenix company activities in the building and construction industry.[64]

8.90 Section 16LA makes all members of a group jointly liable for the payroll tax debts of other group members, regardless of whether or not the group member pays wages. It provides that if a member of a group of related corporations fails to pay an amount that the member is required to pay under the Act, every member of the group is liable jointly and severally to pay that amount to the Commissioner. It was introduced with effect from 1 January 2001 to deal with the problem of phoenix operators ensuring that none of their companies that paid wages held any worthwhile assets.

8.91 The NSW Office of State Revenue commented positively on the effectiveness of s 16LA in dealing with phoenix arrangements:

> None of the phoenix operators audited since the introduction of s. 16LA have refused to settle pay-roll tax debts incurred after 1 January 2001. They also have kept their current obligations up to date. Section 16LA can also be used even if a phoenix operator has already liquidated a company within the group after 1 January 2001, which has happened on a number of occasions.[65]

8.92 The proposals to introduce corporate group liability or contribution or pooling orders raise complex and even radical implications for corporate law. The Advisory Committee in its *Report on Corporate Groups* has given the most comprehensive consideration to this potentially complex proposal. It looked in detail at the various grounds under current Australian law for holding a parent company liable for the debts of an insolvent group company or for setting aside particular intra-group transactions involving an insolvent group company. It examined possible reforms

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61 *Submission* 45, Schedule A, p. 16.

62 Volume 8, Reform – National Issues Part 2, Chapter 11, Payroll Tax Obligations – Non-compliance.

63 Volume 8, Reform – National Issues Part 2, Chapter 11, Payroll Tax Obligations – Non-compliance, p. 106.

64 Recommendation 131.

65 Volume 8, Reform – National Issues Part 2, Chapter 11, Payroll Tax Obligations – Non-compliance, p. 101. (para. 28).

involving the circumstances in which any solvent company in a corporate group should be liable for the debts of failed members of that group and how the claims of other group companies should be treated in the insolvent winding up of a group company. Having considered the current legislation, and reports such as the Harmer report and overseas developments in this area, CASAC made a number of recommendations which the Committee believes warrants the Government's close and immediate consideration.

8.93 The Committee, however, received no detailed submissions on the question of corporate group liability. Debate about the scope for corporate group member liability is at an early stage. Accordingly, the Committee has not given this potentially complex issue detailed consideration. The Committee notes the Government's concerns about adopting s 16LA type provisions in the administration of the taxation system.[66] It shares these concerns and also has concerns about the broader adoption of such provisions. However, it recommends that the insolvency related implications of the Advisory Committee's *Report on Corporate Groups* should be examined by the Government and its findings made available to the Committee.

Recommendation 36

8.94 The Committee recommends that the insolvency related implications and recommendations of the Companies and Securities Advisory Committee's *Report on Corporate Groups* should be examined by the Government and its response made available to the Committee as soon as possible.

Part 5.8A—Employee entitlements

8.95 Another measure introduced recently to assist in the recovery of debts is the Corporations Law Amendment (Employee Entitlements) Act 2000. It incorporated Part 5.8A into the Corporations Act and was passed in 2000. This newly introduced part sets out a regime for the protection and recovery of employee entitlements where agreements and transactions have been entered with the intention of defeating the recovery of entitlements. Part 5.8A allows an employee to sue a person for their entitlements. It is expressed in broad language and entitles an employee to sue any person regardless of their capacity within or external to the company. This addition to the Corporations Act is discussed in chapter 10 on employee entitlements.

Conclusion

8.96 This chapter has considered the impact of fraudulent phoenix company activities and measures for their prevention. It has looked at the current provisions for the disqualification of directors and suggested that the legislation take a firmer position on banning directors for dishonest conduct intended to deceive or defraud creditors. It has also recommended that measures be put in place to improve the

66 See Table of Government's response to the 212 Recommendations of the Royal Commission into the Building and Construction Industry.

collection and availability of databases so that the detection of fraudulent phoenix activity is more effective. The evidence considered in this chapter reinforced the Committee's findings from the previous chapter that funds need to be made available to investigate the failings of assetless companies.

8.97 The following chapter continues the Committee's examination of the adequacy of the current reporting practices and follow-up investigations and considers their effectiveness in detecting and deterring breaches of the Corporations Act.

CHAPTER 9

THE REPORTING AND CONSEQUENCES OF SUSPECTED BREACHES OF THE *CORPORATIONS ACT 2001*

9.1 Administrators, liquidators and receivers are subject to a continuing obligation to report to ASIC suspected breaches of the Corporations Act, any misapplication of funds, negligence, default, breach of duty or breach of trust by past or present company officers or members. On providing such a report they must furnish ASIC with any relevant information and give ASIC access to and facilities for inspecting and taking copies of any documents as it requires.[1] Reports of offences may also be required to be made as a result of a court order.[2] Liquidators are specifically required to report on whether an insolvent company is unable to pay its unsecured creditors more than 50 cents in the dollar.[3] There is also provision for external administrators to lodge further reports specifying any matter which they think should be brought to the attention of ASIC. There are, in addition, other reports that are required to be lodged by external administrators.

9.2 The above provisions are among the most important mechanisms in the law for bringing to light possible breaches of the Corporations Act. It is vital that this function be performed to a high standard as external administrators are the primary investigators of the affairs of insolvent companies.

The lodgement of statutory reports

9.3 The 1998 *Study of Voluntary Administrations in NSW* found that there was evidence of substantial non-compliance with the requirement for voluntary administrators to notify the ASC of suspected breaches of the Law.[4] The findings of the Working Party in the 1997 Review of the Regulation of Insolvency Practitioners are also relevant. It recommended that the ASC work together with the professional bodies to develop guidelines to assist practitioners identify the types of possible misfeasance on which the ASC is focusing from time to time and provide some indication of the level of detail that the ASC expects in reports.

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1 Section 422(1) (reports by receiver), s 438D(1) (reports by administrator), s 533(1) (reports by liquidator).

2 Sections 422(3), 438D(3) and 533(3).

3 Section 533(1)(c).

4 1998 Australian Securities Commission commissioned research paper, *A Study of Voluntary Administrations in NSW*.

9.4 In response to the 1998 study, ASIC instituted a program of inspections of voluntary administrations for the purpose of gauging the level of compliance with the law.[5] It announced the results of its review in March 2000, noting concerns that statutory reports were not being prepared by administrators and lodged with ASIC. As a result of its review, it initiated discussions with industry practitioners and professional groups such as the IPAA.[6]

9.5 Strengthened arrangements for the lodgement of statutory reports by external administrators are reflected in Practice Note 50 (PN 50), which provides guidance to external administrators concerning their reporting and lodgement obligations under the Corporations Act. It sets out specific guidance on preliminary reports, reports of suspected contraventions of the Corporations Act, supplementary reports and lodgement of other documents such as reports as to affairs and accounts, notifications and resolutions.[7]

9.6 PN 50 also facilitates a supportive framework for insolvency practitioners to carry out their functions. It establishes arrangements whereby insolvency practitioners can promptly advise ASIC of serious matters requiring urgent action (such as where assets are at risk of dissipation or a person who may have contravened the law is leaving the jurisdiction)[8] or serious contraventions of Australian laws.[9] It outlines assistance for liquidators commencing proceedings for contraventions of the law,[10] and action that ASIC may initiate in response to reports lodged by external administrators including informing the external administrator that ASIC does not intend to institute proceedings. It establishes a framework and arrangements for lodging reports,[11] indicates the minimum content of reports,[12] and outlines measures to enforce external administrators' obligations with respect to reports.[13]

9.7 As noted in chapter 4, the Corporations Act requires directors to give external administrators a report as to the affairs of a company (RATA) within a specified time of the external administration commencing. ASIC has indicated that it is prepared to prosecute company officers where they fail to provide a RATA when requested by a liquidator, administrator or receiver. The Committee notes that ASIC has issued

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5 ASIC Media Release, ASIC to conduct surveillance inspections program on voluntary administrations, 17 November 1999.

6 ASIC Media Release, ASIC announces results of voluntary administrations review, 28 March 2000.

7 ASIC Practice Note 50, External administrators: reporting and lodging.

8 PN 50.11.

9 PN 50.20.

10 PN 50.24.

11 PN 50.38-50.48, PN 50.52-50.55 and PN 50.58-50.61 (supplementary reports).

12 PN 50.46.

13 PN 50.27-50.32.

strong warnings to directors and officers of failed companies about their obligations to hand over the company books and provide information about assets to company liquidators and has instituted a program of prosecutions in support of these requirements.

9.8 ASIC advised the Committee that its External Administration Project (EXAD) now complements arrangements for the lodgement of statutory reports.

> To assist with the filing of these reports and to reduce the cost of compliance with these provisions, ASIC updated in December 2002 its guidance about reporting to ASIC contained in Practice Note 50 External Administrators—Reporting Matters and Lodging Documents. This update is part of a major project by ASIC to enable insolvency practitioners to lodge documents with ASIC electronically. This project is referred to as the EXAD (External Administration) Project. The EXAD project has simplified the process for the provision of ss 422, 438D and 533 reports (on results of investigations) by receivers, administrators and liquidators, respectively. ASIC has simplified the form and information to be submitted to it and implemented efficiencies by making provision for electronic rather than paper lodgement of reports. Since the introduction of this service in 2002, liquidators have supported this initiative, with reports received electronically by ASIC now approaching 50% of all reports received.[14]

9.9 ASIC envisages that with the simplification of this process a significant increase in the timely lodgement of reports will occur.

9.10 The Committee acknowledges the strengthened arrangements that are in place to ensure the timely lodgement of external administrators' statutory reports. However, it considers that it is not just the fact of the lodgement of statutory reports that is an issue. As the Committee has noted in relation to RATAs,[15] the quality of external administrators' statutory reports must also be considered. The Australian Taxation Office highlighted the problem of the information available in corporate insolvencies.

9.11 It expressed concern that when administrators are appointed, the company records are often incomplete. The expense of bringing the records up to date is often costly and may not be done if there are insufficient funds available to the administrator or liquidator. In the absence of accurate and up to date records, administrators and liquidators are prevented from providing creditors with a full and complete assessment of the company's financial position and potential for recovery of preferential payments. It also means that ASIC is denied full and informative reports about possible wrongdoing. The lack of adequate records has additional consequences for the Tax Office if the company has failed to lodge returns and statements due prior to the appointment of the administrator or liquidator.[16]

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14 *Submission* 24, p. 11.

15 See Chapter 4, The Duties of Directors.

16 *Submission* 14, p. 4.

Recommendation 37

9.12 The Committee recommends that in its enforcement programs for the lodgement of external administrators' statutory reports, ASIC also take greater account of the quality of reports provided.

Consequences of suspected breaches

9.13 Of greater concern to the Committee is the criticism levelled at ASIC for its apparent lack of action where a report, raising suspicions of possible offences committed by the company and its directors, is provided to the Commission but the allegations do not appear to be followed up. Mr Paul Bastian, AMWU, told the Committee:

> In any instance where we have found insolvent trading or any other improper conduct, we write to ASIC and ask whether or not there will be an investigation into the circumstances surrounding the collapse. On at least two occasions, ASIC have written back to us and said no, there were not sufficient resources for them to chase directors in all cases of companies going into administration and that they had to target their funds selectively to try to set precedents in the prosecution of directors. Indeed, we had one senior administrator tell us that if he were to go through his records his estimate would be that, on 98 per cent of cases where he has referred to improper or illegal activity, there has been no further action by ASIC whatsoever.

9.14 He was of the view that although ASIC are the enforcer of the laws:

> …they are not given sufficient teeth to actually go after companies and enforce those laws. It is self-evident to us—and they have made it plain to us—that there are insufficient funds for them to carry out that litigation. So we see that there is a need to increase funding to ASIC so they can act as a real deterrent in these instances.[17]

9.15 Mr Lucas echoed the same sentiments:

> Receivers and Administrators often reported what they believe to be, quite serious breaches of the Corporations Act to the regulator, only to receive the response that due to the lack of resources and the number of complaints received not all matters can be investigated and therefore no further action will be taken.[18]

9.16 He considered that there needed to be far greater emphasis on trying to pursue more matters. In particular, he argued that in respect of small to medium enterprises, a greater emphasis in trying to pursue directors to improve corporate governance may

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17 *Committee Hansard*, 11 November 2003, p. 344.

18 *Submission* 33, p. 9.

have a far more deterrent effect than just looking at the large public company failures. He also suggested more liaison with the industry and the regulator as to what matters the regulator will pursue may improve the reporting requirements, thus promoting better corporate governance.[19]

9.17 CPA Australia expressed a similar concern:

> A source of constant frustration by Liquidators is the situation when blatant breaches of the Corporations Act are reported to the ASIC without any action being taken to bring the offenders to task. This has, over the years resulted in Liquidators either not giving due attention to reports to the ASIC or giving those reports a lower degree of priority. The result is that either insufficient supporting detail is provided in the reports or they are provided at a late stage of the administration making evidence gathering and successful prosecution even more difficult. This lack of prosecution has given rise to the commonly held view that directors can get away with just about anything because the ASIC is unlikely to prosecute unless the company or its directors are of sufficiently high profile.[20]

9.18 A number of submissions considered that ASIC did not have the resources available to it to enable it to investigate properly and prosecute suspected breaches of the Corporations Act. They urged greater action by ASIC and increased funding for it to undertake such activity.[21] The ATO commented:

> The Tax Office supports prosecution activity conducted by ASIC, recognising it as a vital element in maintaining general compliance with the [Corporations] Act.[22]

9.19 Mr David Kerr, official liquidator, stated that in his opinion less than 10% of suspected breaches of the law are investigated by the Commission:

> the regulator must be adequately resourced to enable it to undertake its statutory obligations including the investigation and prosecution of reported breaches of the Corporations Act 2001 by directors of small companies.[23]

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19 *Submission* 33, p. 9. See also Mr Crutchfield, *Committee Hansard*, 7 August 2003, p. 124. He stated that 'there need to be some sorts of professional standards where there is a regulatory body…who can strike a person off. At the moment that can only be done through ASIC. ASIC will probably have already told you, or will tell you, that they have obviously got limited resources'.

20 *Submission* 23A, p. 6.

21 *Submission* 6, p. 12; *Submission* 12, p. 8.

22 *Submission* 14, p. 6.

23 *Submission* 6, p. 12.

9.20 A number of submissions also referred to a lack of resources as a major impediment to ASIC's ability to investigate allegations of breaches of the Corporations Act.[24]

Action taken by ASIC in relation to statutory reports

9.21 In response to the Committee's inquiries, ASIC provided a more detailed analysis as to the nature of the action taken in relation to statutory reports for the 2002-03 year.[25] Its 2002-03 annual report indicated that it received 6,176 statutory reports from external administrators in 2002-03. Of these, 925 reports (15%) reported no offences, leaving 5,251 reports alleging that offences had been committed.

9.22 The annual report recorded that 0.5% of statutory reports were investigated, 6.9% were resolved by information provided/negotiation, with 93% of the reports (i.e. 5,744) being analysed, assessed and recorded. It would appear that no further action was proposed to be taken in relation to 5,744 of the statutory reports for 2002-03.[26]

9.23 ASIC informed the Committee that the onus on external administrators in relation to the reporting of offences is high. External administrators are required to report any possible offences even when they believe evidence will not become available to facilitate a prosecution. Accordingly many of the possible offences reported by external administrators under the reporting provisions are unsupportable or may not be prosecutable, for example, because they do not fall within Commonwealth prosecution policy.

9.24 ASIC stated that there were three statistically significant groupings in reports in the following order of significance.

9.25 A notable number of reports alleged that directors allowed the company to trade despite its insolvency in contravention of s 588G of the Act. This was reported in almost 2,400 of the reports received in 2002-03. However, in most cases there was a lack of admissible evidence to support action or the conduct was of a nature more appropriately pursued through civil recovery action by the external administrator.

9.26 Many offences reported were of a very minor nature which ASIC would seldom pursue. For example, in 2002-03 around 640 reports concerned a possible failure to properly keep books and records. These were often not reports of an absolute failure, clearly prosecutable through criminal action, but an indication that the books were inadequate to monitor properly and account for the company's finances, which in many cases directly contributed to the company's downfall. The

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24 For example see Submissions 21 and 35 to the Committee's inquiry into CLERP 9.

25 See correspondence, Mr Mark Drysdale, Executive Director – Public & Commercial Services, 25 November 2003 in relation to the ASIC Statutory Oversight hearing of 26 November 2003.

26 The equivalent figures for 2001-02 are 3,942: ASIC Annual Report 2001-02, p. 59; and for 2000-01, 2,775: ASIC Annual Report 2001-02, p. 48.

Committee has in chapter 4 expressed its concern about the apparent high level of inadequate record keeping of companies in external administration (see recommendations 9 and 10).

9.27 The final statistically significant grouping in reports centres around possible offences against directors' duties. Last year around 300 reports alluded to a potential offence under sections 180–184 of the Act. In many cases these amounted to possible civil contraventions capable of being pursued by the external administrators themselves (to the extent they may have caused damage to the company in question), rather than criminal offences.

Procedures following lodgement of statutory reports

9.28 ASIC informed the Committee that the 5,744 reports that were analysed, assessed and recorded were subject to a roughly identical process. They were initially allocated to a complaint analyst who reviewed the report and conducted relevant searches through ASIC's internal database systems to uncover the history of the subjects of the report. The complaint analyst may also conduct external inquiries, often through the external administrator who lodged the report, to obtain further details about evidence that may be available. Armed with this information, the officer would compare the information with ASIC's confidential selection criteria. Where the report does not meet the criteria, the complaint analyst would record details of the possible offences reported and record his/her assessment of the matter, with a decision that ASIC should take no further action. The relevant external administrator is advised.

9.29 ASIC received 25 complaints that specifically identified possible contraventions of Part 5.8A. These primarily arose out of reports from insolvency practitioners under s 533. The 25 matters were subject to assessment and detailed examination against a range of issues. Of the 25 matters, 23 were finalised without requiring further enforcement action. In these cases the reasons for not taking further action related primarily to a lack of evidence on an offence having been committed. Two matters were being investigated.[27]

9.30 ASIC has advised that during the 11 months until 31 May 2003 it took the Commission an average of 14 days to assess and respond to statutory reports from external administrators. In 88% of cases it assessed the matter and responded within 28 days. During the course of the 2003-04 year, ASIC has advised that it proposes to implement key efficiency indicators and procedures that will consolidate its level of response.[28]

9.31 ASIC noted that liquidators' reports support enforcement action in relation to contraventions of insolvent trading prohibitions and directors' duties. It noted

27 Answers to questions on notice, Treasury Portfolio, Budget Estimates, 3-6 June 2003.

28 Answers to questions on notice, Treasury Portfolio, Budget Estimates, 3-6 June 2003.

successful criminal prosecutions, civil penalty proceedings, and preventative actions in relation to illicit phoenix activities.

ASIC complaints program

9.32 Aside from administrators' reports, ASIC relies on many sources for information on wrongdoing. Insolvency related concerns comprised a substantial component of ASIC's complaints program. Its Annual Report noted:

> Most complaints came from company external administrators, then from investors or shareholders. The most common complaints concerned company officers failing to assist external administrators and acting fraudulently or negligently.[29]

Regional liaison

9.33 ASIC advised that it continues to seek to improve the processes associated with the reporting and investigation into liquidator referred matters. As part of its approach to improving its relationship with the profession, it has regional insolvency liaison arrangements that include both insolvency lawyers and insolvency practitioners, which aim to improve its understanding of the needs of the insolvency industry and improve delivery of its services and programs in this area.[30] ASIC has emphasised a concern to continue liaison arrangements with the IPAA on both a national and regional basis.[31]

9.34 The Committee is supportive of such comprehensive liaison arrangements with insolvency professionals.

9.35 Clearly, a number of insolvency practitioners have the firm impression that insufficient attention is being given to their reports. It is a feature of many enforcement regimes including corporate regulation that regulatory authorities often have insufficient resources to ensure compliance with regulations. Further, full enforcement of insolvency related legislation is not always desirable or possible and resource decisions inevitably involve trade-offs between different government programs and objectives. Nevertheless, the Committee is concerned that there is a widespread perception by parties affected by the collapse of insolvent enterprises that corporate laws are inadequately enforced in the context of insolvencies.

9.36 International regulatory bodies have promulgated Objectives and Principles for corporate and securities regulation. For example, in September 1998 the International Organisation of Securities Commissions issued its Statement of Objectives and Principles of Securities Regulation. Principle 6.4, concerning the designated regulatory authority, specifies that the regulator should have adequate

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29 ASIC Annual Report 2002-03, p. 52.

30 *Submission* 24, p. 11.

31 Address, Commissioner Collier, IPAA annual conference, 28 May 2003.

powers, proper resources and the capacity to perform its functions and exercise its powers.

9.37 It is not clear to the Committee whether the regulator has the resources to perform its functions in relation to corporate insolvencies or that the importance of ASIC's insolvency functions are adequately recognised in the law. No specific mention of ASIC's insolvency role is provided in the statement of its corporate aims in s 1(2) of the Australian Securities and Investments Commission Act. The Committee considers that inadequate funding of the designated regulatory authority in relation to corporate insolvency laws can represent a serious misallocation of a country's resources given that the impact of corporate insolvencies can be widespread and devastating for so many people.

9.38 Despite the explanations from ASIC on its procedures in following-up reports of possible offences, the Committee is not convinced that sufficient priority is being given to the assessment and investigation of reported possible serious breaches of the Corporations Act. If this is a matter of perception over substance, then ASIC has a responsibility to establish with insolvency practitioners a better system of conveying to them that it has given due and careful attention to the contents of their reports. ASIC needs to reassure insolvency practitioners that their reports are taken seriously and investigated where necessary.

9.39 If indeed, in setting its priorities, ASIC is unable to investigate adequately reported breaches of the Corporations Act because of a lack of resources, then as an independent statutory body it should make its concerns known.

9.40 The Committee stated in chapter 2 that its foremost objective in this Inquiry was to promote and maximise trust and confidence in the operation of insolvency law on the part of the community in general and the business and corporate sector in particular. If creditors, debtors, the courts and the general public are to have confidence in the administration of Australia's corporate insolvency laws, there must be confidence in the regulatory system.

Recommendation 38

9.41 The Committee recommends that the level of funding for ASIC take account of the demands and complexities of corporate insolvency laws and the need to investigate properly and enforce contraventions of the law exposed by corporate collapses.

Recommendation 39

9.42 The Committee requests that ANAO conduct a performance audit of ASIC's processes in receiving and investigating statutory reports.

Statistical reporting

9.43 The Committee considers that there is scope to enhance the quality of information collated and/or published in relation to companies that are the subject of statutory reports by external administrators, so as to improve its usefulness to management, journalists, academic researchers, the public, Parliament and the Government. Additional information could include estimates of the level (number) of strategic insolvencies (phoenix companies), the incidence of cases raising the possible application of director disqualification provisions,[32] the incidence of so-called assetless companies, the incidence of strategic insolvencies involving the use of corporate groups,[33] the incidence of liquidations that returned less than 50c in the dollar to creditors, the number of cases involving holding company liability for insolvent trading by a subsidiary,[34] the incidence of fraud, the incidence of cases involving a shortfall in the payment of employee entitlements and the incidence of cases involving a shortfall in the payment of superannuation.

Recommendation 40

9.44 The Committee recommends that ASIC consider enhancing its capacity to provide more comprehensive, comparable analyses of statutory reports of liquidators for the assistance of journalists, academic researchers, the public and the Government and its own management requirements. Such information should be assessed in terms of maintaining public confidence in the administration and enforcement of corporate laws.

9.45 As noted above, in 2002-03 around 640 reports disclosed a possible failure to keep books and records properly. Section 286 embodies one of the most fundamental principals of corporate law, the requirement for a company's financial records to disclose the financial position of the company at all times and at any time. The effective investigation and administration of the affairs of an insolvent company is dependent on the integrity of records kept and compliance with s 286. The Committee has noted the concerns of the Taxation Office about the extent of non-compliance with the s 286 requirement. Creditors and shareholders also have a vital interest in the maintenance of such records.

9.46 In chapter 4, the Committee recommended that the Government review the penalty regime for section 286 with a view to making the penalties a more effective deterrent. Increased penalties alone, however, will not remedy the problem of poor record keeping. There needs to be rigorous reinforcement of section 286. The Committee believes that poor record keeping is a matter that warrants close attention by ASIC and an area where breaches should not be tolerated.

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32 Sections 206C-206F.

33 For example, of the kind outlined in the Cole Royal Commission Report: see pp. 115-26 of Volume 8.

34 Section 588V.

Recommendation 41

9.47 The Committee recommends that ASIC continuously evaluate the incidence of possible failures to keep books and records adequately as disclosed in external administrators' reports on an annual comparative basis. This measure would allow ASIC to assess the effectiveness of its annual programs for the enforcement of financial reporting requirements.

9.48 This chapter has considered regulatory responses to the reporting and consequences of suspected breaches of the Corporations Act. The following chapter considers a further aspect of the rights of creditors—employee entitlements.

CHAPTER 10

THE TREATMENT OF EMPLOYEE ENTITLEMENTS

10.1 When a company is wound up it will rarely be the case that all of the creditors of the company will be paid in full. A fundamental concern of insolvency law, therefore, is to devise fair arrangements and rules for rationing the available assets of an insolvent company amongst the competing claims of creditors. This chapter is concerned solely with employee entitlements in the context of a company's failure.

10.2 In addressing the treatment of employee entitlements, submissions focused on five particular issues:

- the ranking of debts, including employee entitlements, in the order for payment under current insolvency law;
- the proposal to pay out certain employee entitlements ahead of all other creditors, including secured creditors, upon liquidation (the 'maximum priority proposal'—MPP);
- the design of General Employee Entitlements and Redundancy Scheme (GEERS);
- other possible schemes for the payment of employee entitlements; and
- the treatment of superannuation in a corporate insolvency context.

The ranking of creditors in insolvency administrations

Secured creditors

10.3 The order for the distribution of assets in the case of insolvent Australian companies is as follows. Firstly, secured creditors are entitled to be paid out of the secured assets outside the winding up provisions. Secured assets strictly do not form part of the assets available for distribution in a winding up. Those assets can extend to anything from land to plant and equipment, motor vehicles, fixtures and fittings, particular pieces of machinery or things such as patents or intellectual property. If there is a surplus or shortfall in the realisation of secured assets the balance is treated as an unsecured asset or claim.

Preferred creditors

10.4 Secondly, preferential creditors are paid in the order set down in s 556 which governs the payment of certain unsecured debts in priority to all other unsecured debts. In effect, it establishes the regime for preferred creditors. It confers preferential status, firstly, on the costs, charges and expenses of the winding up. The list of

administrative costs is lengthy due to the fact that there are various components of the costs, charges and expenses of a winding up.

10.5 It then confers preferential status on employee entitlements. The provisions relating to the costs, charges and expenses of the winding up (ss 556(1)(a)-(df)) and employee entitlements (ss 556(1)(e)-(h)) in turn differentiate between the various components of those expenses and establish a ranking among them for payment.

Unsecured creditors

10.6 Ordinary unsecured creditors rank next in the order for payment. This class includes trade creditors, subcontractors, insurance policyholders, Crown debts and the unsatisfied claims of secured creditors. The law also recognises the concept of deferred creditors, creditors who by private agreement consent to subordinate their claims to those of other creditors. Unsecured creditors are paid out of any available unsecured property. Any residue remaining after payment of secured and unsecured creditors will be divided among shareholders. Where there are preference shareholders, their entitlements will be determined in accordance with the terms of issue. Finally, ordinary shareholders will participate equally in the remaining assets.

Employee entitlements

10.7 As noted above, under the current law, in the distribution of the property of an insolvent company, employees enjoy a superior priority over other unsecured creditors such as suppliers, subcontractors, customers and creditors whose debts are secured by a floating charge.

10.8 In the case of a receivership, the Corporations Act sets out obligations for the repayment of certain debts in priority to those owed to debenture holders. Employee entitlements are included in the debts given priority. The priority only applies to property subject to a floating charge. As in a liquidation, property subject to a fixed charge is not accorded priority.

10.9 In the case of a voluntary administration or a deed administration, there are no mandatory priority repayment provisions. Employee entitlements are not accorded priority in such situations. However, in many Deed of Company Arrangements (DCAs), the same statutory priority that would apply in a liquidation is provided for. Employees are unlikely to support a DCA if it did not give them a result at least equal to what they would obtain in a liquidation. The DCA is examined in detail in chapter 11.

10.10 The provisions governing employee entitlements differentiate between the various kinds of entitlements and establish a ranking among these expenses for payment. They are paid in the following order: firstly, wages and superannuation contributions in respect of services rendered to the company by its employees before the commencement of the winding up; secondly, amounts due in respect of injury compensation; thirdly, amounts due to an employee under an industrial agreement for

leave of absence; and fourthly, retrenchment payments due to employees of the company.

10.11 Other provisions are intended to further enhance the prospect of payment of employee entitlements. Section 558 aims to ensure that employees do not lose priority for annual and long service leave which was still accruing but had not fallen due at the commencement of the winding up.

10.12 Section 561 provides that payments of employee entitlements must be made in priority to the claims of a chargee in relation to a floating charge created by the company and payments may be made out of any property comprised in or subject to the charge. In effect employees have a super priority over floating charge secured assets.

10.13 In summary, under the current law employee entitlements rank highly in the statutory order of payment. Aside from administration costs they have priority over all other unsecured creditors, including Commonwealth and State taxation authorities and ordinary unsecured creditors. In contrast to comparable countries' insolvency regimes, the priority of employee entitlements is not subject to caps. Preferred creditor status for employees is one element of statutory arrangements that aim to ensure that employees recover all or most of their entitlements. In many cases it will generally satisfy a significant portion of those claims but, given the nature of insolvency, it will not guarantee the entirety of employees' claims.

The pari passu principle and employee entitlements

10.14 Legislative provision for preferential debts in insolvency regimes has long been a source of contention in discussions of insolvency policy. On one view it is seen to be unfair that unsecured creditors frequently lose out on any benefits in a liquidation because of the existence of preferential rights. It is argued that the rights of preferential creditors have not been developed pursuant to any considered policy.[1] In practice the existence of preferential debts means that there is little scope for the application of the *pari passu* principle.

10.15 The *pari passu* principle has been a fundamental feature of insolvency law since its origins and is currently embodied in s 555 of the Corporations Act. That principle dictates that, in the compulsory collective realisation procedure that insolvency law imposes on the parties, unsecured creditors should rank equally and where there are insufficient assets to cover all liabilities—which will usually be the case—they should have an equal entitlement to share in a proportionate distribution of the available assets.

10.16 Debts due to employees, however, have been afforded priority in the event of insolvency for over two hundred years, which in itself is indicative of a clear and long

1 Andrew Keay and Peter Walton, "The Preferential Debts Regime in Liquidation Law: in the Public Interest?', 1999 *Company Financial and Insolvency Law Review*, 3. pp. 84-105.

standing public interest in the protection of employees under insolvency law. Priority for wages owed to domestic servants was provided for in Scotland as far back as 1799 and for clerks and servants in England in 1825. This was extended to 'labourers and workmen' in 1849.[2] Early adaptations of corporate insolvency laws in Australia in State enactments retained the principle of priority for employees in insolvency laws.

10.17 Traditionally, the employee has been seen to be in a different bargaining position in comparison with other creditors and investors. A number of submissions argued that the impact of an employer's insolvency is likely to be more serious for employees as a group than the effect on other creditors. Wages are likely to be the only source of income for employees while other creditors have access to other sources of income. Employees are risk bearers with limited job mobility. In negotiating the terms of their employment, employees are rarely able to seek provision for protection against employee insolvency. In most circumstances independent contractors are able to write off bad debts.

10.18 Both the Harmer and the Cork Reports, however, expressed concerns that preferential debts may be inconsistent with the principle of equal treatment of creditors. In the view of the Cork Committee there is little doubt that an elaborate system of priorities causes much dissatisfaction. It stated:

> there is widespread demand for a significant reduction, and even a complete elimination, of the categories of debts which are accorded priority in an insolvency.[3]

10.19 In turning to employees as creditors, the Harmer Report questioned the priority afforded employee entitlements. It noted:

> The principal rationale for the employee priority has been significantly diminished by the development of a sophisticated social welfare system. Further, the effect of the priority is to deprive other unsecured creditors of their claim to a share of the available assets.[4]

10.20 Taking a similar approach, some submissions questioned the statutory priority afforded employee entitlements or proposed a reconfiguration of the regime. Mr Bradley Peppink, who has written on insolvency law, argued that the priorities afforded employee entitlements should be removed. In his view their rationale was uncertain and unjustifiable and come at an unjustifiably high price to the insolvency process generally. In his view:

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2 Keay, Andrew and Walton, Peter, 'The Preferential Debts Regime in Liquidation Law: in the Public Interest?', 1999 *Company Financial and Insolvency Law Review* 3, 90.

3 Report of the Insolvency Law Review Committee, Insolvency Law and Practice, Cmnd 8558, (1982) [1397].

4 ALRC Report No 45, vol. 1, para. 727.

> They deviate from the fundamental principle of insolvency law that seeks to achieve an equal distribution of the insolvent's estate relying on unsubstantiated assertions concerning employee vulnerability...these priorities significantly reduce the assets available to satisfy the claims of ordinary unsecured creditors, thereby diminishing their capacity to withstand debtor default.[5]

10.21 The CPA commented that:

> While the concept of providing priority as a level of protection to employees from employer insolvency is long standing in Australian business, it may be open to question as to whether the principle is equitable as against sub-contractors and other creditors of similar standing.[6]

10.22 It further commented:

> …subcontractors are de facto employees of the company and are dependent for the major part, if not all, their income, from a single source. These people are just as vulnerable as employees and perhaps consideration ought to be given to giving them a priority similar to that awarded to employees.[7]

10.23 Most submissions, however, supported the need for insolvency law to recognise the need to protect employee entitlements through the priority conferred by the Corporations Act. Their support for affording preferential treatment to employee entitlements is consistent with Australia's international obligations.

10.24 Australia is a signatory to the International Labor Organization Convention concerning the *Protection of Workers' Claims in the Event of the Insolvency of their Employer*.[8] Many countries throughout the world give some manner of protection to employee entitlements in the event of employer insolvency. The employment relationship has long been seen as a qualitatively distinct and different relationship from other trading relationships and is recognised and supported by an extensive body of law.

10.25 The Committee understands that there are compensatory measures that are available to trade creditors that are not available to employees. Retention of title clauses provide some means of protection for certain types of subcontractors. Courts have generally given effect to many such security devices. Also, the scope to monitor

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5 A paper submitted for the Research Paper, Faculty of Law, ANU, November 2002, in *Submission* 4, p. 37.

6 *Submission* 23, p. 11.

7 *Submission* 23, p. 11.

8 See http://www.austlii.edu.au/ Australian Treaty Series 1995 No 13. Articles 5 and 8 embody the principle of the priority accorded to workers' claims in the distribution of the employer's assets in insolvency.

creditors is more readily available to other types of creditors. The Independent Contractors Association of Australia noted:

> For independent contractors, the key to minimising exposure to insolvent entities is to exercise discipline over credit and invoice payment. The exposure of independent contractors to bad debt is generally constrained to the period in which an invoice has been delivered to a client and payment is pending. In this context, independent contractors should ensure that when selling their services they include strict payments terms as a condition of their contract and should be prepared to stop supplying services or goods if payment is not made within the payment terms. If all independent contractors stuck to this practice, then exposure to bad debt from insolvent entities would be minimised.[9]

10.26 State security of payment legislation in relation to particular industries and State statutory security/lien legislation also affords a measure of protection against phoenix companies and insolvent trading for independent contractors.[10]

Maximum priority proposal (MPP)

10.27 Even though employees occupy a priority place in the rating of creditors, the Government recently put forward a proposal to place employee entitlements before secured creditors (the maximum priority proposal). In effect, this proposal would grant employee entitlements a maximum or super priority over all other creditors.

10.28 At a press conference on 14 September 2001, the Prime Minister announced a decision that in future the statutory entitlements of employees in a liquidation of a company that employed them would rank ahead of the entitlement of secured creditors. Statutory entitlements include pay, long service leave, holiday pay.[11]

10.29 The Government's November 2001 election policy statement entitled 'Choice and Reward in a Changing Workplace' restated the Government's position as outlined by the Prime Minister two months earlier:

> To secure the entitlements of all Australian workers, the Coalition will give unpaid employees (wages, annual and long service leave and pay in lieu of notice) priority over secured creditors (such as banks and finance companies) when a business becomes insolvent. The Coalition will balance the impact on business against the importance of employers complying with their legal and moral obligation to pay the entitlements of their employees.

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9 *Submission* 47, p. 4.

10 Vicki Vann, 'Another Way of Dealing with Phoenix Companies', (1998) 10 *Corporate and Business Law Journal* 141.

11 In September 2001 the Minister for Employment, Workplace Relations and Small Business announced that 'the Government intends to provide maximum priority to statutory employee entitlements in the event of insolvency putting annual and long service leave entitlements ahead of new secured creditors'.

An exemption will be considered to eliminate any impact on small business lending.

10.30 On 26 June 2003, Mr Andrew Sellars, Treasury, told the Committee:

> The consultation process on the policy is complete. What is happening now is that the policy is being refined and decisions will need to be made by government on the policy. The draft legislation would then be produced and further consultations would take place at that point, but at this stage it is still a matter of settling the policy…[which is] expected to be bedded down in the next three months.[12]

10.31 Further features of the maximum priority proposal included:

- The maximum priority rule would only apply where the amount of a company's unsecured assets and assets secured by a floating charge are insufficient to ensure the full payment of the company's maximum priority employee entitlements.
- The maximum priority rule would apply to all charges created in any way, including mortgages and would apply only to charges created after the commencement of the new rule.
- The rule would not apply to all employee entitlements. The entitlements to be paid out of secured assets would include unpaid wages, accrued annual leave, payment in lieu of notice and long service leave. Redundancy payments and unpaid superannuation contributions would be excluded.
- Where there is more than one secured creditor, each would contribute on a proportionate basis less the costs and expenses incurred in realising the secured property.
- The new priority rule would only cover employees of large corporations. It would not apply to small businesses or individuals.
- Any contribution by secured creditors towards payment of the maximum priority employee entitlements would take into account any costs and expenses incurred by a secured creditor in realising secured property.
- Secured creditors would be required to contribute if they realise a security within a certain period (proposed to be six months or one year) prior to the liquidation.

10.32 In essence, the maximum priority proposal (MPP) would rank employee entitlements ahead of fixed charge assets where unsecured and floating charge assets are insufficient to meet those entitlements. It represents a departure from longstanding

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12 *Committee Hansard*, 26 June 2003, p. 16.

principles for the distribution of available assets in a corporate insolvency. Under the present system, assets that are the subject of a fixed security may only be used to pay the debts of the holder of the security. Employees have a priority over floating charge assets, the day to day assets, of the company but do not have a priority over the fixed charge assets of the company.

10.33 The Australian Council of Trade Unions (ACTU) and the Australian Workers' Union (AWU) strongly supported employee entitlements having an absolute priority ahead of all other creditors, including secured creditors, upon liquidation.

10.34 In the AWU's view, banks enjoy distinct advantages over other creditors. They set interest rate premiums to compensate for their risk when capital is lent to companies. They have access to key financial data to constantly update the assessment of risk to their loans. They can queue jump the priority of employees by taking a fixed charge over secured assets. The AWU added:

> Employees, by contrast, lend companies their entitlements on trust for no interest rate premiums. They do not receive adequate and timely information comparable to that available to banks.[13]

10.35 The AWU said that first priority for employees would lessen the burden on the taxpayer, as there would be a decrease in the use of government/taxpayer funded schemes such as GEERS.[14] It also expressed concern about the meaning of 'employee entitlements' for the purposes of the MPP. It proposed that employee entitlements for the purposes of maximum priority should be defined as long service leave plus all accrued entitlements and redundancy pay as per the relevant industrial instrument applying at that company's workplace, including superannuation.[15] The ACTU stated that:

> the positioning of employee creditors before secured creditors is justified as it is the employees who are least able to bear the burden of company collapses, are least able to position themselves to avoid loss and have no control over how monies that would be otherwise used to pay their entitlements are utilised by their employer.[16]

10.36 Support for the MPP was also expressed by Mr Crutchfield. In his opening testimony before the Committee he said:

> [E]mployees should have priority over the fixed charge element of the charge. Clever lawyers have emasculated the provisions of the floating

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13 *Submission* 39, p. 6.

14 GEERS, which is a government-funded scheme designed to protect the entitlements of employees whose employment has been terminated due to their employer's insolvency, is discussed later in this chapter.

15 *Submission* 39, p. 6.

16 *Submission* 32, pp. 8-9.

> charge priority through the charges over book debts. The weakness in the provisions becomes evident when you are dealing with situations like that of a company that runs a coal mine, which is only a hole in the ground and does not have any floating charge assets, or, if there are debtors and the bank has a fixed charge over them, there is nothing there. I think that ought to be fixed.[17]

10.37 He later added:

> The way the priority provisions work at the moment for employees is that they have priority over the floating charge element of the bank's charge. In my opinion, the original rationale was that the employees, through whose work the fund is administered for the benefit of the bank, should get their wages paid as a priority; they should take priority over the bank. That is the way it was done in Victorian England. Now, as I said in my opening statement, clever lawyers have emasculated the floating charge element, and I think the original purpose has been undermined. Employees should take priority over the whole element. It would also do away with arguments about what is fixed and what is floating.[18]

10.38 On the other hand, many submissions were critical of the maximum priority proposal. A number of associations opposed, or expressed varying degrees of reservations about, the introduction of the MPP. They were concerned about the impact of the proposal on the availability of credit, commenting that it would lead to a contraction of credit. This point was reiterated numerous times. Submissions also pointed to the priority that employees already enjoy under the current law and indicated strong support for the retention of the GEERS scheme. They considered that the Government stood to benefit from the adoption of a super priority for employees as it would serve to defray the Government's exposure under GEERS. In its view the proposal would have a widespread economic and social impact and the costs of the proposal would be passed on to businesses.

10.39 Insolvency practitioners and representative accounting bodies were also critical of the MPP. In the IPAA's view the likely causes of unpaid entitlements were lack of capital in small to medium companies, increases in redundancy liabilities arising out of negotiated salaries and wages agreements and the lack of understanding by directors of cash flow needs, insolvent trading laws and the effect of insolvency on the reduced sale value of assets. It believed that the MPP did not address these fundamental problems:

> The current proposed changes will put greater responsibility on banks to ensure that employees' entitlements are protected. This takes the emphasis

17 *Committee Hansard*, 7 August 2003, p. 124.

18 *Committee Hansard*, 7 August 2003, p. 135.

> from the custodians of the business, i.e. the directors, to be responsible for their actions.[19]

10.40 Ms Alison Tierney of the Australian Finance Conference also elaborated on this point:

> …we believe that the maximum priority rule is not behaviour changing. It places the onus for our members on us—to monitor their behaviour and make sure they are behaving correctly. So we think that implicit in that is that if there is going to be some sort of reform in this area it should actually produce behaviour change, but in the right place within the organisation.[20]

10.41 A number of witnesses identified what they believed were flaws in the proposal. They included the following:

- the objective (to protect employee entitlements and minimise the Government's exposure to the funding of GEERS) was unlikely to be achieved because the majority of unpaid employees of insolvencies are in small businesses and the proposed legislation only applies to large companies;[21]
- due to administrative difficulties banks will encounter in dealing with and discharging their securities, lending practices will be changed to overcome the potential loss of security (loans will be made to companies holding assets without employees);[22]
- companies with fixed charge assets in entities which had employees will reorganise their affairs so that the fixed charge assets will be removed from the entities which have the employees;[23]
- it may lead to a proliferation of companies employing staff, but holding no assets other than a receivable from an associated trading or operating company;[24]
- it attacks the rights of the legal owners of the property in question—any elevation in the rights of any class of unsecured creditor, including

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19 *Submission* 22A, Appendix 1.

20 *Committee Hansard*, 11 November 2003, p. 328.

21 *Submission* 22A, Appendix 1, IPAA submission to ASIC Treasury Discussion Paper on Employee Entitlements: Proposal to give priority over secured creditors, 22 August 2002.

22 *Submission* 22A, Appendix 1.

23 *Committee Hansard*, 7 August 2003, p. 136.

24 *Submission* 6, p. 12.

employees, comes at a reduction in the funds available to other creditors who have also been victim to the insolvency of the debtor;[25]

- the proposal would impact on small business (greater difficulty in borrowing, increased interest rates as a consequence of banks' reduction in security, less tolerance by banks in times of a minor liquidity crisis);[26]

- difficulties in defining the boundaries of small business—for example a bank will not know into the future whether a business will move from a small business category into a large business one or vice versa;[27]

- it would place Australian employers in an uncompetitive position compared to other countries and drive further casualisation of the work force;

- the concept of 'fixed security' was uncertain—is it restricted to fixed charge debentures or does it include other forms of security such as liens, garnishee orders, Income Tax Assessment section 218 orders, statutory liens, leases, hire purchase agreements and subcontractor liens?[28]

- the MPP would place pressure on companies to adopt contractor and sub-contractor arrangements rather than employer and employee arrangements to mitigate the effect of the proposed legislation.[29]

10.42 The Ai Group made the point that direct impacts include higher lending rates, reduction in credit availability to many businesses and, in some cases, businesses may have credit withdrawn completely. Effects may be particularly severe on those companies with long-serving work forces (and thus high employee entitlement provisions).[30] Other impacts mentioned by the Ai Group include:

- banks may respond to the change in the priority of employees' entitlements by seeking security for loans over personal assets of proprietors and directors —this may stifle entrepreneurship;

- the impact would be greater on companies with labour intensive operations (those in the clothing and footwear industries) because such companies typically have a higher level of accrued entitlements, and on companies which employ long-serving full-time staff (those in the manufacturing industry) rather than those employing short-term and/or casual staff;

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25 *Submission* 19, p. 4.

26 *Submission* 23A, p. 11.

27 See for example *Committee Hansard*, pp. 61 and 264.

28 *Submission* 23A, p. 12.

29 *Submission* 23, Appendix C.

30 *Submission* 28, p. 1.

- it would drive further casualisation of the workforce;
- companies would be more reluctant to enter into new loans (given the arrangements banks would insist upon)—this would negatively impact upon investment levels;[31] and
- if the company goes into default, banks and other financial institutions will have their security eroded by the value of the employee entitlements elevated in priority. This increased lending risk has to be priced into the structure of the loan, consistent with sound risk management principles.[32]

10.43 Overall, the Australian Manufacturing Workers' Union (AMWU) expressed these reservations about the MPP:

> Elevating employee entitlements above secured creditors with fixed charges against the company's assets will increase lending rates, reduce, or withdraw available credit to many businesses and hinder company growth. 'Potentially this could result in other innocent workers losing their jobs and bearing the price, or small business simply being unable to afford new employees' (Abbott. 2001: 11). Changing the MPR will only raise the cost of doing business and therefore adversely affect Australia's international competitiveness. It will increase the degree of risk to lenders, which naturally will be passed on through higher charges.[33]

10.44 From this wide range of concerns, the impact of the proposal on the availability of credit, on lending arrangements and small business dominated the discussion. These three issues are discussed in the following section.

Impact on credit availability

10.45 Mr Millin of GE Commercial Finance noted that his company is principally an asset-based lender focusing heavily on the fixed assets of the balance sheet. It does not reserve for employee entitlements against senior secured loan availability when lending against fixed assets (debtors, plant and equipment and property). He maintained that the MPP would make such a reserve necessary and would result in a reduction in senior secured borrowing capacity for affected companies. Mr Millin also commented on the impact of the MPP on a cash flow lender:

> I believe a cash flow lender looking at a cash flow loan will still look to the value of the assets to support the total amount of senior secured debt that they will lend. They will probably not approach the assets on the balance sheet in as mechanical and mathematical a fashion as we do. My view is that

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31 *Submission* 38, p. 4.

32 *Submission* 28, p. 2.

33 *Submission* 45, p. 16.

> it would still have an impact on a cash flow lender's appetite for a certain level of debt.[34]

10.46 Mr Hossack, ABA, told the Committee:

> Early on, when the policy was announced, the feeling was that this would mainly be an effect on price, as in the banks would accept the risk and increase the premium. However, the more we have looked at it—and I think the more the banks have—the weight of opinion is tending towards that it is probably going to have more of an effect on the loan limit rather than the premium.[35]

Impact on lending arrangements.

10.47 Many submissions commented on the impact of the MPP on lending arrangements. Points made included that:

- The proposal would impose on lenders the cost of undertaking a detailed 'due diligence' on employee entitlements before making a loan. Undertaking this task before a loan is made will be a costly and time consuming exercise and increase the cost of loans made to corporations which have a large workforce.[36]
- The costs of monitoring the security position will give rise to greater costs for the secured lenders which will in turn be passed on.[37]
- The proposal will provide lenders with less security and make it difficult for borrowers to obtain finance. It will lead to the insolvency of 'marginal' businesses that may otherwise have been viable in the long term.[38]

Impact on small business

10.48 The NFF also opposed the MPP and expressed support for the current system. It understood that the Government would be likely to exempt small business from the priority rule but was still concerned about the indirect adverse impact of the MPP on

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34 *Committee Hansard*, 11 November 2003, p. 327.

35 *Committee Hansard*, 11 November 2003, p. 336.

36 *Submission* 23, Appendix C, Submission by Law Council in September 2002 to Commonwealth Department of Treasury.

37 *Submission* 23, Appendix C, Submission by Law Council in September 2002 to Commonwealth Department of Treasury. It will be necessary for a lender to monitor the business of the company to which it has extended finance to ensure that the borrower is able to meet its employee entitlement obligations without exposing the secured asset to the liquidation. In practice, this will be difficult and create a monitoring cost, which will most likely be passed on to the debtor company or generally to businesses securing finance. *Submission* 27, Attachment: AICD submission to Treasury, 30 august 2002; and *Submission* 44, p. 2.

38 *Submission* 27, Attachment: AICD submission to Treasury, 30 August 2002.

NFF members. In its view the reduction in the concept of security for financial lenders:

> would substantially alter the risk assessment and risk management practices taken by those institutions resulting in increases on rates of lending and stricter criteria as to access to finance by all businesses regardless of their size.[39]

10.49 COSBOA commented:

> Our concern about changing existing practice is the compliance cost and detrimental effects it would have on employment if the current situation is changed. Often small businesses are very empathetic to their employees and will often use their own personal funds to meet their employees' entitlements when the business is failing as compared to big business failure.[40]

10.50 CPA Australia concluded that the MPP would be 'no more than a band aid solution'. It argued that it 'does not address the real issues and may create an economic environment that makes it more difficult for small businesses especially as secured creditors adopt countermeasures to protect their positions'.[41]

10.51 In summary, Mr Stephen Smith, Australian Industry Group, told the Committee:

> …we have taken the time to look at that issue in some depth. In doing that we have consulted with our members and we have had some relatively detailed discussions with the banks about the issue. We are now convinced that that proposal would significantly disadvantage both employers and employees. Companies experiencing financial pressures would be most affected by the proposal and almost certainly finance would be much harder for struggling companies to obtain. It is quite logical that that proposal, if it proceeds, would lead to an increase in the number of insolvencies because of that very fact. In conclusion, we believe that the existing laws and other arrangements in place to protect employee entitlements in Australia are fair and balanced and are operating effectively.[42]

10.52 The Committee notes that the World Bank's *Principles and Guidelines* for insolvency systems include two principles pertaining to secured credit. Principle 3 asserts that the legal framework should provide for the creation, recognition and enforcement of security interests. Principle 4 asserts that enforcement systems should provide efficient, inexpensive, transparent and predictable methods for enforcing a

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39 *Submission* 30, p. 2.

40 *Submission* 16.

41 *Submission* 23A, p 12.

42 *Committee Hansard*, 8 August 2003, p. 148.

security interest in property. The *Principles and Guidelines* recognise that in some countries unpaid wages, taxes and many other debts come ahead of a security interest but note that the result was that the benefits of secured credit are unavailable. The commentary to the *Principles and Guidelines* states:

> Any priority placed ahead of the secured party represents a substantial cost, which is generally transferred back to borrowers in the form of higher interest rates and transaction costs. Often the public policy represented by the priority (say, benefiting workers) receives a minor and occasional benefit at a substantial cost to the entire commercial system. Such priorities should be eliminated, reduced, and, where public policy concerns are compelling, addressed by other legal reforms that do not compromise the system for secured lending.[43]

10.53 The Committee considers that the protection of employee entitlements in the circumstances of employer insolvency is an important public policy and it is appropriate for governments to explore options for better protecting such entitlements. The Government's foreshadowed proposal to pay out certain employee entitlements ahead of all other creditors, including secured creditors, does not appear to the Committee to be the most effective means to achieve this objective. The Committee is not persuaded that the ranking of debts for payment under the current law should be altered.

10.54 The factors that the Committee has taken into account in reaching this conclusion include:

- the uncertain impact on secured lending practices;
- the potential increased cost of secured lending and the passing on of these costs to borrowers;
- greater complexity in the conduct of external administrations;
- avoidance behaviour by secured creditors to protect their positions;
- the impact on businesses that have large numbers of employees or long serving employees relative to those that do not;
- tensions arising from the differential treatment of large and small businesses and confusion arising from a change in status when a small company becomes a large one and vice versa; and
- the long hiatus period in which the legal effect of the maximum priority proposal will be uncertain.

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43 World Bank, *Principles and Guidelines for Effective Insolvency and Creditors' Rights Systems*, April 2001, Commentary, p. 21.

Recommendation 42

10.55 The Committee recommends that the maximum priority proposal not be adopted. The emphasis in any reform proposals in relation to employee entitlements should be on preventative measures to minimise the risk of loss of employee entitlements and modifying current behaviour to ensure directors and managers of companies take greater responsibility in meeting the cost of employee entitlements in the event of business failure.

The recovery of employee entitlements

Corporations Law Amendment (Employee Entitlements) Act 2000

10.56 As noted in chapter 8, the Parliament passed the *Corporations Law Amendment (Employee Entitlements) Act 2000* which incorporated Part 5.8A into the Corporations Act. This newly introduced part sets out a regime for the protection and recovery of employee entitlements. It seeks to deter the misuse of company structures and other schemes to avoid payments to employees that they would be entitled to in a liquidation.[44] Part 5.8A is expressed in broad language and entitles an employee to sue for their entitlements any person regardless of their capacity within or external to the company.

10.57 Section 596AB states plainly that a person must not enter into a relevant agreement or a transaction with the intention of, or with intentions that include the intention of, preventing the recovery of the entitlements of employees of a company or significantly reducing the amount of the entitlements of employees of a company that can be recovered. The legislation is intended to send a very clear message to corporate employers that deliberate avoidance of obligations to employees is not acceptable. Its aim is to alter directors' behaviour in regard to the payment of employee entitlements.[45]

10.58 The Parliamentary Joint Committee on Corporations and Financial Services inquired into the Corporations Law Amendment (Employee Entitlements) Bill and found that the evidence reflected wide and diverse views on the proposals. Although acknowledging that the legislation would extend the liability of directors for insolvent trading, a number of witnesses were of the view that it would not adequately protect employees' entitlements. Others were worried about exposing directors to unreasonable risk of further personal liability.[46]

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44 See Explanatory memorandum to the Corporations Law Amendment (Employee Entitlements) Bill 2000, para. 18.

45 See Second reading speech, Senator Richard Alston, Minister for Communications, Information Technology and The Arts, Senate Hansard, 16 March 2000, p. 12978.

46 Parliamentary Joint Committee on Corporations and Financial Services, *Report on the Corporations Law Amendment (Employee Entitlements) Bill 2000,* April 2000, paragraph, 3.25, pp. 7–8.

10.59 One major concern, however, centred on the effectiveness in applying the legislation. A number of witnesses spoke of the evidentiary difficulties in establishing intention and the likelihood that few successful prosecutions would eventuate under the proposed provisions. For many the evidentiary requirements of the criminal standard of proof would defeat the intention of the Bill. For example the SDAEA was not alone in suggesting that proposed Part 5.8A was a 'toothless tiger' in that it may be 'very difficult, if not impossible, to prove the necessary intent'. It concluded:

> The reality is that the offence would be so hard to prove that nobody will be effectively prosecuted. The solution is to expand the Part to catch any agreement that has the effect of preventing or significantly reducing recovery of entitlements'.[47]

10.60 At the time the Committee was examining the Corporations Law Amendment (Employee Entitlements) Bill 2000, the Companies and Securities Advisory Committee (CASAC) was preparing its final report on Corporate Groups. Among other things, it was considering the law for holding a parent company liable for the debts of an insolvent group company or for setting aside intra-group transactions involving an insolvent group company. It noted that 'under the Corporations Law, an Australian holding company can be liable for the debts of its insolvent subsidiary on various grounds, including as a shadow director, or where it should have reasonably suspected its subsidiary was insolvent.'[48] It was of the view, however, that Part 5.7B Div 5 which imposed liability on a holding company for debts of its subsidiaries had various limitations.

10.61 CASAC explored a number of possible reforms to this area of the law and considered a recommendation of the Harmer Report that 'Australian courts should have specific powers to make contribution or pooling orders where the affairs of a corporate group have been intermingled'.[49] CASAC explained that under a contribution order:

> A court can require a group company not being wound up to contribute specific funds to cover all or some debts of another group company in liquidation.[50]

CASAC did not support the Harmer recommendation.

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47 Parliamentary Joint Committee on Corporations and Financial Services, *Report on the Corporations Law Amendment (Employee Entitlements) Bill 2000,* April 2000, paragraph, 3.25, p. 11.

48 Companies and Securities Advisory Committee, *Corporate Groups: Final Report,* May 2000, p. 145.

49 Companies and Securities Advisory Committee, *Corporate Groups: Final Report,* May 2000, p. 158.

50 Companies and Securities Advisory Committee, *Corporate Groups: Final Report,* May 2000, p. 159.

10.62 Of relevance to employee entitlements is CASAC's reference to the new s 596B dealing with entering into agreements or transactions with the intention of avoiding the payment of employee entitlements. It concluded that:

> Given its general disposition against court contribution orders, it is not appropriate to recommend these orders for the benefit of employees in addition to any legislation which is specifically tailored to the circumstances of employee entitlements.[51]

10.63 The application of Part 5.8A to corporate structures is still to be tested. The Committee notes that the amendment has not yet been the subject of detailed consideration by the courts. It considers that the provisions of Part 5.8A are quite wide and are likely to encompass many persons regardless of their relationship to the company. The coverage of the provisions is a matter for the courts to consider as a matter of statutory interpretation.

10.64 Even so, evidence presented to the Committee during its inquiry into the Bill strongly suggested that the evidentiary requirement would frustrate the intention of the Bill. It is now four years since Part 5.8A came into force, and in light of the fears that prosecutions would be unlikely, the Committee believes that it is time to commence a review of the operation of Part 5.8A.[52]

10.65 In chapter 8 on Phoenix companies, the Committee described a number of ways that companies structure their corporate businesses to avoid their obligations to creditors particularly employees. For example, under one form a management company will own the assets and equipment used to run the business while a separate phoenix company will operate the business and employ the workers but have no assets. When the phoenix company accumulates debts and goes into liquidation as an assetless company, the management company continues to trade. Another form involved a management company, a sales company and a labour hire company.[53]

10.66 The Committee is concerned that the problem of corporate structures being used to avoid paying employees their entitlements may not be adequately addressed by the Corporations Law Amendment (Employee Entitlements) Act. Further that CASAC's review of Corporate Groupings did not have the opportunity to explore thoroughly corporate structures and phoenix company activity. The Committee believes that a review of the Act should also contemplate the wider context in which the obligations to meet employee and more generally creditors' entitlements are avoided particularly through the structuring of corporations.

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51 Companies and Securities Advisory Committee, *Corporate Groups: Final Report,* May 2000, p. 166.

52 The Act was assented to on 30 June 2000.

53 See paragraphs 8.9–11.

Recommendation 43

10.67 The Committee recommends that the Minister for Finance request the Corporations and Markets Advisory Committee to review the operation of the *Corporations Law Amendment (Employee Entitlements) Act 2000* to determine its effectiveness in deterring companies from avoiding their obligations to employees. Furthermore, in light of the evidence suggesting that some corporations deliberately structure their business to avoid paying their full entitlements to employees and more generally unsecured creditors, the Committee recommends that the review look beyond the effectiveness of the Act and consider, and offer advice on, possible reforms that would deter this type of behaviour.

The General Employee Entitlements and Redundancy Scheme

10.68 An important element of Commonwealth arrangements for the protection of employee entitlements in the event of employer insolvency is the General Employee Entitlements and Redundancy Scheme (GEERS) which protects the entitlements of employees whose employment has been terminated due to their employer's insolvency. Under the scheme, where an employee has a legal entitlement derived from legislation, an award, a statutory agreement or a written contract of employment, as at the date of his/her former employer's insolvency, he/she may be eligible to receive payments in respect of:

- unpaid wages;
- accrued annual leave;
- accrued long service leave;
- accrued pay in lieu of notice; and
- up to 8 weeks redundancy entitlements (as per community standard).

10.69 Payments made under GEERS are subject to an annual income cap ($75,200 for 2001-02, $81,500 for 2002-03 and $85,400 for 2003-04). Eligible claimants who earn more than the scheme's cap are paid as if they earned a rate equivalent to the scheme's income cap.

10.70 Benefits paid under the scheme are recoverable by the Commonwealth. The Act allows a person who advances money to a company for the purpose of that company paying wages, superannuation contributions, leave of absence or termination of employment entitlements under an industrial agreement to prove in the liquidation as if that person was an employee: s 560. Anyone who wishes to put a liquidator in funds to pay employee entitlements will have the same priority position formerly enjoyed by the employees for those funds. Under GEERS the Government may rely on this provision effectively to stand in the place of the employees in a liquidation and

enjoy the priority in any distribution which those employees would otherwise have had in the liquidation.

10.71 If a deed of company arrangement (DCA) is proposed and the creditors vote for a deed rather than for the company to be wound up, the deed must include the priorities of subsection 556(1) of the Act in relation to the entitlements to be paid to employees. In relation to any advances for payments of employee entitlements, the deed presented to the creditors for their consideration must provide for the same priority as the Commonwealth would receive under s 560 of the Act in relation to such an advance under a winding up.

10.72 If at the end of the administration the company is restored to the directors (other than pursuant to a DCA) and continues to trade, the loan which the Commonwealth has advanced is to be repaid within 4 weeks of the end of the administration.

10.73 Mr John Lloyd, DEWR, made the point that it is Government policy that 'employers are and must remain responsible for meeting the costs of their employee entitlements'.[54] Mr Peter Anderson, ACCI, endorsed this approach stating that GEERS 'should not be seen by industry as a transfer of its obligation to the governments'. He explained:

> We have communicated throughout industry that the GEERS scheme is a scheme in which the government is making some upfront payments and then standing in the shoes of the creditors. We do not think any arrangements should be put in place by companies, whether under the Corporations Law or otherwise, which would undermine that proposition.[55]

10.74 Similarly, the AWU expressed the view that it should be business and not the taxpayer that takes primary responsibility for employee entitlements.[56]

10.75 Many submissions commented positively on GEERS as a feature of overall arrangements for the protection of employee entitlements. Some saw it as a great improvement on the previous scheme.[57] Mr Anderson told the Committee that:

> Our analysis of the way in which GEERS is now operating, which is different to the way in which the original employee entitlements support scheme operated, is that GEERS has by and large operated well and, in the overwhelming majority of cases, it is providing relief to persons who are

54 *Committee Hansard*, 26 June 2003, p. 34.

55 *Committee Hansard*, 7 August 2003, p. 71.

56 *Committee Hansard*, 8 August 2003, p. 159.

57 See for example, evidence by Mr Watts, *Committee Hansard,*7 August 2003, p. 98.

> employees of businesses where there is insolvency and where there are unpaid entitlements.[58]

10.76 No submission proposed that GEERS be abolished. The ACCI was of the view that:

> …the GEERS scheme, together with changes already made to corporations law, whilst not able to provide a perfect solution to what is an imperfect situation, is the best of the immediately available policy options given the broader negative consequences of other alternatives, and should at least be given an opportunity to operate for a substantial period of time before any further significant public policy intervention occurs.[59]

10.77 Despite the general approval given to the scheme, a number of witnesses wanted payments to be extended or increased. Mr Richard Watts, ACTU, told the Committee:

> Our view is that it does not go far enough. It should be covering all employee entitlements, and there is good reason for that. We believe, particularly, that what is missing is redundancy payments in excess of eight weeks. In many cases those redundancy payments have been traded off in lieu of giving pay rises and other benefits, as part of enterprise bargaining. That has been a trend, you will find, particularly in those industries which are vulnerable, where there is structural change. In the manufacturing and textile, clothing and footwear industries you will often find more generous redundancy arrangements, but they have often been achieved by the forgoing of pay rises over the years, where the employees' higher priority is on protecting themselves in the case of redundancies. So we see no justifiable reason for limiting it to eight.[60]

10.78 Mr Trent Gillam, AWU, agreed. He stated that the AWU is of the opinion that the scheme should be broadened to pay redundancy according to the relevant industrial instrument and cover unpaid superannuation entitlements.[61] Mr Paul Bastian, AMWU, told the Committee that an eight-week cap is 'a nonsense—that it is a basic minimum; it is certainly not a community standard'.[62]

10.79 In the Committee's view, GEERS is an important aspect of the overall arrangements for the protection of employee entitlements in Australia and should continue to be a feature of those arrangements. As to extending its coverage, the Committee believes that it should cover superannuation entitlements, particularly in light of steps that have been taken to ensure that employees superannuation

58 *Committee Hansard*, 7 August 2003, p. 59.

59 *Submission* 13, p. 10.

60 *Committee Hansard*, 7 August 2003, p. 98.

61 *Committee Hansard*, 8 August 2003, p. 159.

62 *Committee Hansard*, 11 November 2003, p. 349.

contributions are being made (see paragraphs 10.108–10.110 and recommendation 47).

Alternative mechanisms for protecting employee entitlements—industry funds, insurance schemes etc

10.80 A number of submissions raised the question of possible alternative mechanisms for protecting employee entitlements including industry trust funds, employer-employee insurance schemes and employer levies. These various schemes were presented to the Committee as a means of quarantining employee entitlements from the risks of business failure. Indeed, the Harmer Report recommended the creation of a wage earner protection fund financed by employers and possibly employees as an alternative to employee priority but accepted that there was strong support for the retention of the existing priority accorded to employees.[63]

10.81 Mr Kevin Davis and Mr Geoff Burrows provided the Committee with a paper in which they advocated the adoption of a Deferred Benefit Account proposal for the protection of employee entitlements. The Deferred Benefit Account concept envisages employers maintaining balances that equate to reasonable aggregate provisions for accrued employee entitlements (annual and long service leave) in designated accounts. Legislation would support the maintenance and operation of the accounts. In the authors' view the concept would complement GEERS type schemes and other legislation and sanctions to deter employer attempts to diminish the value of employee entitlements in a liquidation.

10.82 In the AMWU's view, a better solution to the maximum priority rule was to place employee entitlements in an independent trust fund. It argued that if employee entitlements were set aside in a trust there would be no need to change the status quo. There is no guarantee that secured assets would be sufficient to satisfy employee entitlements in any given case. The AMWU considered that removing the employer's capacity to tamper with accrued entitlements would protect vulnerable employees from the detrimental effects of phoenix companies and general insolvent companies. The National Entitlement Security Trust (NEST) effectively deals with the issue of employee entitlement in insolvency while providing benefits to all related stakeholders.[64]

10.83 The proposals for insurance schemes or trust funds as a means to protect employee entitlements faced strong resistance from some sectors of the industry. Mr Anderson, ACCI, told the Committee:

> We have not been convinced that an insurance scheme is an appropriate policy response. Our concerns with the insurance scheme mirror some of the concerns I mentioned earlier about the trust funds—that is, whether it is a

63 ALRC Report No 45, vol. 1, para. 727.

64 *Submission* 45, pp. 17-24.

> proportionate response; whether you are imposing an obligation across the whole of an industry, or across the profile of employers generally, to make payments or pay compulsory levies on the basis of seeking to protect entitlements, which the overwhelming bulk of companies would be paying and would not be giving rise to circumstances where claims on the insurance were actually required. We do not think it is a proportionate response. It is a compulsory levy and, in that sense, it is a compulsory tax. We do not think that is good for the economy or for job creation. It is effectively another compulsory tax on jobs.[65]

10.84 Taking up this line of argument, Mr Smith, Australian Industry Group, said:

> If all companies are forced to insure for entitlements, even assuming for a moment that it just covered the entitlements that GEERS covers, so you have a consistent standard, you are then forcing successful companies to pay for the entitlements of employees of unsuccessful companies. That, in our view, is unfair. Why should a successful company that has done everything right and has protected the entitlements of its own employees pay the entitlements of some other company's employees? That is just as unfair…[66]

10.85 Mr Watts, ACTU, accepted that there will be 'different courses for different horses'. He explained:

> If employers can put forward arrangements where they can ensure that employees' funds are secure—whether it be through security arrangements, fixed charges over certain assets or other arrangements where employees' moneys are secured—there may be middle grounds where arrangements can be utilised where employees, in the absence of super preference, can get first call on those resources because of those secured arrangements. There are arrangements that have been entered into in many cases where that has occurred. That has allowed employees some degree of comfort and resolved what has been on the ground a real industrial relations concern and in the broader sense allowed for greater productivity as a result. Trust funds are one way to resolve those issues. We think that it is part of the answer; it is not the full answer and it is not going to be the appropriate answer for all business. But for many businesses it is an answer which can make sense.[67]

10.86 The Committee notes that the proposals for the establishment of insurance schemes or trust funds are a major departure from the current system and would require a thorough examination and extensive consultation with industry before even preliminary models could be produced. The Committee believes that the proposals are worthy of further attention but suggests that much ground work would need to be done before any serious consideration could be given to the proposals.

65 *Committee Hansard*, 7 August 2003, p. 71.

66 *Committee Hansard*, 8 August 2003, p. 155.

67 *Committee Hansard*, 7 August 2003, p. 99.

Recommendation 44

10.87 The Committee recommends that the Government explore the various measures proposed for safeguarding employee entitlements such as insurance schemes or trust funds giving particular attention to the costs and benefits involved in the schemes.

The reporting of employee entitlements in financial statements

10.88 A number of submission from the Trade Union sector supported the proposal whereby directors in their annual reports be required to report on the provisioning for employee entitlements. For example, the AWU believes that the best option to avoid the loss of employee entitlements is to take appropriate and preventable action prior to insolvency occurring. In its view, such action could be possible by an employer providing to the union, on a regular basis, reports about the financial position of the company and, in particular, its ability to meet its obligations in relation to employee entitlements.[68] The ACTU put forward a similar proposal. Mr Watts who looked at reporting obligations as a means to protect employee entitlements told the Committee:

> It is about early intervention. It is about looking at some of the warning signs. It is about information sharing and employees having the opportunity to look at the state of play of a company and be provided with proper details of contingent and accrued liabilities and company's steps to secure those—at least to ensure that they are in an informed position as potential creditors or creditors of the company.[69]

10.89 Mr Gillam endorsed this approach arguing that employees should be informed about the ability of the business to meet accrued and contingent liabilities. To his mind that is 'what an early warning system would provide'.[70]

10.90 Representatives from the Business Sector seemed to have no difficulty accepting the requirement to report on accrued employee entitlements and agreed that it is 'good practice'. Some pointed out that the information is already available in the company's financial statements which are audited.[71]

10.91 Mrs Catherine Mulcare, CPA, informed the Committee that financial reports are prepared in accordance with the accounting standards which are a separate part of the law. She made clear that:

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68 *Submission* 39, p. 3.

69 *Committee Hansard*, 7 August 2003, p. 96.

70 *Committee Hansard*, 8 August 2003, p. 167.

71 *Committee Hansard*, 8 August 2003, p. 153.

> The ability to say whether or not something should or should not be reported in the financial reports is limited by the legal requirements of these standards.[72]

10.92 To the same effect, AICD was of the view that directors are already required to ensure that the company accounts for provisions for employee entitlements and discloses the provision in the annual accounts. It noted that:

> This obligation arises from Section 286 of the Act, which requires a company to keep written financial records that correctly 'record and explain its transactions and financial position and performance' and would enable 'true and fair financial statements to be prepared and audited'.[73]

10.93 Mr Anderson also acknowledged that there are certain reporting obligations for public companies which are very important. In his view it was 'crucial that industry takes those obligations seriously and applies them fully'. He added, however, that it is 'a little more difficult, when you get to smaller proprietary companies, to impose those same standards of reporting obligation'. He told the Committee:

> Businesses which already have processes which provide that information have mechanisms set up to do that, and providing that information to employees is unlikely to be an additional cost to them. Businesses that do not have reporting mechanisms—a smaller business or a proprietary company, for example—will have to put an additional process in place, even though they would be undertaking what is generally good practice.[74]

10.94 The business sector, however, baulked at the suggestion that reporting obligations include contingent employee entitlements. According to Mr Anderson, the issue of reporting contingent liabilities presented difficulties. He noted:

> Information about your contingent liability is only meaningful on the supposition that you are going to be making employees redundant, because that is the act that gives rise to the contingent liability. Even in the broad, the quantum of liability that you can identify at a given point in time by way of contingent liability will change as your labour force profile changes.[75]

10.95 The AICD also drew attention to what it perceived as a distinction between accrued and non-accrued entitlements:

> Accrued entitlements such as unpaid wages, annual leave and long service leave are qualitatively different from non-accrued entitlements such as redundancy pay and pay in lieu of notice. Redundancy payments, for

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72 *Committee Hansard*, 8 August 2003, p. 178 And see discussion of Australian Accounting Standard ASSB 1028 in chapter 4.

73 Additional information.

74 *Committee Hansard*, 7 August 2003, p. 62.

75 *Committee Hansard*, 7 August 2003, p. 62.

> example, are made in extraordinary circumstances, not in the ordinary course of business. It is an inefficient use of a company's capital to have to set aside provisions of such a contingent nature, nor are such provisions consistent with the ongoing nature of a business.[76]

10.96 Mrs Mulcare again referred to the accounting standards and what is required under law:

> As such, whether or not CPA Australia believes that a particular contingent liability should or should not be recognised for a redundancy is fundamentally affected by the law which limits a preparer's ability to do that. Certainly, there are no limitations on other areas of the financial statements, such as other reports, but there are limitations in accordance with the current accounting standards and the way they are written in the recognition of those liabilities as well as the ability to include its contingent liability.[77]

10.97 Mr Lopez also noted the opportunity for the company to report on matters such as contingent liabilities other than in the financial statement as set down by accounting standards. In his personal view; 'for the sake of clarity, either within the balance sheet or within the notes to the accounts, there should be some declaration as to what the company's contingent liabilities are'.[78]

10.98 The ACTU also suggested that directors and company officers, having asserted that there is adequate provisioning, be personally liable if employee entitlements cannot be met in the case of insolvency.[79] Again such a suggestion met strong opposition from the Business sector.

10.99 In summary, the AICD considered that given the existing obligations on directors, 'the proposal to have directors additionally sign-off that there is adequate provisioning would create unnecessary duplication'. It added, however:

> Perhaps more could be done to ensure that directors, employees and investors understand the nature and scope of these existing obligations.[80]

10.100 The Committee strongly supports the reporting of employee entitlements in annual reports. It acknowledges that for many companies this requirement is already in place. On the question of reporting contingent liabilities, the Committee notes that companies are able to report such information in a variety of ways—notes to accounts or in the directors annual report—that would clearly demonstrate that the company has taken account of contingent liabilities in assessing its financial standing. The

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76 Additional information.

77 *Committee Hansard*, 8 August 2003, p. 178.

78 *Committee Hansard*, 8 August 2003, p. 175.

79 *Submission* 32, pp. 12–13.

80 Additional Information.

Committee urges companies to review the issues raised by the trade unions during this inquiry and work with them in devising reporting mechanisms that would satisfy their concerns.

10.101 At the moment, the Committee is reluctant to make any further recommendations that expose directors to greater liability. It has already made a number of recommendations that would place directors under increased responsibility and notes further that there are a number of recent initiatives that have not yet had time to take effect.

Superannuation

10.102 Superannuation was another aspect of employee entitlements that raised concerns. A number of submissions proposed that superannuation be afforded a higher priority in an insolvency context. Under the current law superannuation is granted preferred creditor status together with wages, ranking behind administration expenses but ahead of other employee entitlements such as leave, workers compensation and retrenchment payments. Superannuation is not covered by GEERS.

10.103 The IPAA noted that employees who have lost their jobs on their employer's insolvency prefer to receive a distribution as wages rather than as superannuation, which cannot be accessed until retirement. It argued that wages and superannuation should be split into separate categories of entitlements; superannuation should be afforded a higher priority, as it is not covered by GEERS. It would then have a greater chance of being paid as it would no longer be competing with a subrogated claim from GEERS pursuant to s 560.[81]

10.104 The Association of Superannuation Funds of Australia (ASFA) underlined the importance of superannuation, not merely to individual employees but in assisting the Government meet its objectives for its retirement income policy for an ageing society. It proposed that the Government amend the law to give superannuation contributions a higher priority, alongside the expenses incurred in preserving, realising or getting in property or in carrying on the company's business at s 556(1)(a) of the Corporations Act.[82]

10.105 The Association expressed concern that:

> Though priority unsecured creditors, wages and superannuation contributions remain below secured creditors such as banks with outstanding debts, as well as other unsecured creditors such as expenses, administrators and auditors. The decision to rank superannuation contributions below other expenses is a concern given that superannuation is

81 *Submission* 22B, p. 7.

82 *Submission* 11A, p. 2.

> not merely an employee entitlement but also a statutory obligation on employers to help meet Australia's future retirement income needs.[83]

10.106 The Committee does not consider that the ranking of superannuation contributions in s 556(1) should be altered. It notes that superannuation contributions rank along with wages at the top of the order for payment of employee entitlements in s 556(1)(e). It would not be appropriate to rank such entitlements above administration costs. Arguably administration costs are not strictly debts of the company but the collective costs of creditors incurred in the process of realising the assets of the company and distributing them to creditors. If one disregards administration costs, superannuation contributions together with wages rank ahead of all other unsecured debts. By virtue of s 561, superannuation contributions rank ahead of holders of floating charge assets. Only secured debts over fixed assets are paid out ahead of wages and superannuation contributions.

10.107 Even so, the Committee is concerned about the likelihood of any loss of superannuation benefits. It accepts the argument about the importance of superannuation and during its deliberations on this matter focused on measures to ensure that contributions are made and protected rather than to trying to recover lost contributions after a company fails. The recently introduced quarterly payment of the superannuation guarantee charge is one such measure designed to keep any losses to a minimum.

Enforcement arrangements for superannuation contributions

10.108 From 1 July 2003, employers have been required to make at least quarterly, as opposed to annual, superannuation contributions on behalf of their employees. There are sanctions for failing to pay contributions on time. If an employer fails to make the required superannuation guarantee payments the superannuation guarantee becomes a superannuation guarantee charge (SGC). The SGC is levied by the ATO and becomes an amount that consists of the superannuation guarantee entitlement, interest on those entitlements and an administration charge. A number of submissions and witnesses supported this initiative as an effective means of increasing the security of employee's entitlements.[84] Dr Bradley Pragnell, ASFA, told the Committee:

> We are pleased that the government has introduced quarterly superannuation guarantee payments effective from 1 July this year. We believe that moving from annual to quarterly payments of the superannuation guarantee is an important move in ensuring and protecting employee entitlements in this important area.[85]

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83 *Submission* 11, p. 2.

84 See for example evidence from Mr Smith, *Committee Hansard*, 8 August 2003, p. 151.

85 *Committee Hansard*, 7 August 2003, p. 139.

10.109 Although most witnesses keenly supported this initiative, some believed that the procedures could be tightened even more. Mr Watts, ACTU, told the Committee:

> If there is a requirement for that issue to be addressed every three months it is likely that if the company goes into insolvency there will still be substantial periods which are unpaid beyond three months. A month would be preferable. It lessens the concern, but we believe there is still a substantial concern there.[86]

10.110 ASFA recommended that the Government review the powers of the ATO to recover and collect superannuation payments in an insolvency situation.[87] It commented that the Superannuation Guarantee operates on the basis that the employer has a superannuation charge liability which may be reduced, or extinguished, by the employer making a contribution to a complying superannuation fund. However, it is only when the employer fails to make the superannuation contribution by the appointed date (as of 1 July 2003, 28 days after the end of the previous quarter) that the SGC assessment may be raised by the ATO.

10.111 It is not until this stage that the ATO has any power to commence collection and recovery of the SGC under the *Taxation Administration Act 1953*. In ASFA's view, this may be many months after an insolvency situation. In the period prior to the raising of the SGC assessment, the ATO has no priority in a pre-liquidation situation, for instance when a company is in administration or under a Deed of Company Arrangement.

10.112 The Committee considers that it is too early to make an accurate assessment of the impact of the quarterly arrangements for the collection of the superannuation guarantee charge and whether strengthened enforcement measures are required. Nonetheless, it welcomes this change as a constructive measure to help minimise the potential loss of superannuation entitlements that employees may face when a company fails. It would like to see the arrangements for the quarterly collection of the superannuation guarantee charge closely monitored and for Treasury to periodically publish its assessments of the operation of the scheme and its effectiveness in safeguarding employees' superannuation benefits.

Recommendation 45

10.113 The Committee recommends that the Government monitor the impact of the quarterly arrangements for the collection of the superannuation guarantee charge to determine whether there is a need for strengthened enforcement measures.

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86 *Committee Hansard*, 7 August 2003, p. 103.

87 *Submission* 11, p. 2.

Perceived inconsistencies between the Superannuation Guarantee Charge and the Corporations Act

10.114 The IPAA drew attention to inconsistencies between the Superannuation Guarantee (Administration) Act ('SGAA') and the Corporations Act. It considered there is a lack of clarity as to how the Superannuation Guarantee Scheme is intended to operate in relation to employers that are under one or other form of external administration.

10.115 The inconsistencies noted by the IPAA are as follows:

- The SGAA only deals with the priority of Superannuation Guarantee Charge ('SGC') in a liquidation. It fails to deal with the priority of the SGC in a receivership, a voluntary administration or a deed of company arrangement.

- There are differing views as to whether SGC amounts are 'superannuation contributions payable by the company in respect of services rendered to the company by employees before the relevant date' for the purposes of s 556(1)(e) of the Corporations Act. SGC amounts are debts to the Commonwealth (s 50 SGAA) and as such may not be amounts payable in respect of services rendered. Accordingly, except for liquidations which are specifically dealt with in the SGAA, it is unclear as to whether SGC amounts are priority debts in a receivership and an administration.

- There are differing views as to the treatment of superannuation entitlements that are not a SGC at the date of appointment. If a liquidator/receiver/administrator is not able to pay these amounts for some time, do they become a SGC? If they do become a SGC after the date of appointment, does the Administration component, Nominal Interest Component and General Interest Charge accrue (even though it is now after the date of appointment)? If these components do accrue after the date of appointment, are they priority amounts under section 556(1)(e)? If there is a SGC outstanding at the date of appointment, does the Nominal Interest Component and General Interest Charge continue to accrue until the date that the SGC is paid (even though it is now after the date of appointment)? If these components do accrue after the date of appointment, is it a priority under section 556(1)(e)? It is unclear how the whole position is affected if a liquidator is appointed after a receiver.

- It is unclear as to whether payments made to the ATO in respect of the SGC will satisfy employees' claims for outstanding superannuation (as proofs may have been lodged by both the ATO and the employee);

- Under the Corporations Act there is a limit on the amount that can be paid to directors as a priority (section 556(1A)). This limit is not recognised in the Superannuation Guarantee Charge legislation.

10.116 The Committee considers that the uncertainties noted by the IPAA about the interaction between the two acts should be reviewed as they may have the result that employees are not receiving their full entitlement.

Recommendation 46

10.117 The Committee recommends that the Government clarify inconsistencies between the Superannuation Guarantee (Administration) Act and the Corporations Act and clarify how the Superannuation Guarantee Scheme is intended to operate in relation to employers that are under one or other form of external administration.

Post-administration superannuation contributions

10.118 In the recent decision of Ansett Australia Ground Staff Superannuation Plan Pty Ltd and Anor v Ansett Australia Ltd and Ors,[88] the Court noted the limitations of paragraph 556(1)(e) of the Corporations Act 2001, with reference to superannuation contributions made after the relevant date (generally the date of the commencement of the liquidation). The Court found that no priority was afforded superannuation contributions after the relevant date.

10.119 ASFA expressed concern that the decision opens up the potential for employees working under an administrator (as was the case in Ansett) to have no priority given to their on-going wages and entitlements if and when liquidation finally occurs.[89]

Recommendation 47

10.120 The Committee recommends that the Government clarify the priority afforded superannuation contributions required to be made after the 'relevant date' of an external administration.

10.121 Another matter that appears to need clarification is the treatment of superannuation under a DCA. The Association of Superannuation Funds of Australia expressed concern that administrators are able to unilaterally implement a deed of company arrangement that relegates superannuation funds with a shortfall to the position of ordinary unsecured creditors.[90]

GEERS and superannuation

10.122 ASFA noted that, unlike wage and leave entitlements, superannuation payments are not covered under GEERS and recommended that the Government

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88 (2002) VSC 576 (20 December 2002).

89 *Submission* 11, p. 2.

90 *Submission* 11, p 4.

consider the inclusion of superannuation contributions in the Commonwealth employee entitlements scheme.[91]

10.123 The Committee did not receive any detailed analysis of the cost of such a proposal or how it could be implemented or whether any eligibility criteria may be appropriate. However, in principle and subject to these necessary qualifications, the Committee is supportive of the proposal. It notes that both the equivalent UK and Irish schemes for the protection of employee entitlements in the event of employer insolvency make provision for occupational pension rights. In the UK, trustees of occupational pension schemes may apply to the employer's representative for payment from the National Insurance Fund, within certain limits, in respect of relevant contributions which remain unpaid at the date of the employer's insolvency.[92] In Ireland the Employers' Insolvency Payments Scheme protects employees' outstanding contributions to occupational pension schemes which an employer may have deducted from wages but not paid to the scheme. The Scheme applies to outstanding pension contributions for up to a year prior to the date of insolvency of an employer

Recommendation 48

10.124 The Committee recommends that the Government consider the inclusion of superannuation contributions in GEERS.

10.125 This chapter has considered features of the law that aim to protect employee entitlements, the ranking of debts, and in particular employee entitlements, in the order for payment under insolvency law and the proposal to pay out certain employee entitlements ahead of other creditors, including secured creditors, upon liquidation. The following chapter considers issues that have been raised about the Deed of Company Arrangement.

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91 *Submission* 11, p. 4.

92 Refer http://www.dti.gov.uk/er/redundancy/insolvency-pl718.htm.

CHAPTER 11

COMPLIANCE WITH, AND EFFECTIVENESS OF, DEEDS OF COMPANY ARRANGEMENT

11.1 On taking control of a company's affairs, the primary task for an administrator is to investigate the financial position of the company with a view to making a recommendation to creditors about what should be done. One of the options open to creditors is to execute a deed of company arrangement (DCA). If a DCA is recommended, the administrator must provide a statement setting out details of the deed. If the creditors vote in favour of a DCA proposed by an administrator, all creditors are bound by it. The DCA details the adjustment of the rights and obligations of creditors in relation to the company.

Contents of deed of company arrangement

11.2 The person who is to be the administrator of the deed must prepare an instrument setting out its terms. The DCA must include some essential matters (such as the property to be available to pay creditors' claims, the duration of any moratorium period for which the deed provides, the extent to which the company is to be released from its debts, conditions for the deed to operate, the circumstances for termination of the deed, order of payment of creditors' claims).

11.3 In addition, the deed is taken to include prescribed provisions set out in schedule 8A of the Regulations. It is not mandatory to include these provisions in every deed; the deed may provide otherwise. One of the provisions is clause 4 of schedule 8A, which provides that the administrator must apply the property of the company in the order of priority specified for a liquidation. The deed, however, may make other provision including altering the priority that would apply in a liquidation.

11.4 The Act attempts to ensure the integrity of DCAs. A Court may terminate a deed where it is satisfied that material information was omitted from the administrator's report, where there has been a material contravention of the deed, or where the deed is oppressive or unfairly prejudicial to one or more creditors, or contrary to the interests of the creditors as a whole.

11.5 Concerns have been expressed about a number of aspects of DCAs. The Taxation Office expressed concerns that a number of DCAs were defaulted on, leading to the company being wound up and creditors failing to receive the amounts pledged under the deed. Another criticism was that companies are increasingly using DCAs to avoid paying their creditors. Finally, that very few deeds yield reasonable dividends to creditors.[1]

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1 *Submission* 14, p. 7.

11.6 In the ATO's view there was a tendency for creditors to accept DCAs that were not viable. The reasons for this may include insufficient or inaccurate information supplied by company directors, inaccurate appraisal or investigation by administrators and inexperience on the part of creditors.[2]

11.7 The following section takes a closer look at the situation where creditors may be disadvantaged in accepting a DCA.

11.8 A number of submissions expressed concern that DCAs can alter the priority of payment in a liquidation. The ATO proposed that the law should require that distributions to creditors pursuant to DCAs must not depart from the principle expressed in s 555, all debts in a winding up should rank equally and, if there is insufficient property to meet them in full, they must be paid proportionately.[3]

11.9 Mr Zwier expressed a contrasting view:

> The Tax Office, in its submission, suggested that discriminatory deeds of company arrangement—that is, where different unsecured creditors get different sums of money—should be disallowed. As someone who reorganises companies, to me such a proposition is repugnant to any sensible reorganisation, and that is because there are always key and vital creditors who need to be paid 100c in the dollar or they are not going to do business with the company in the future. If you took away the ability to discriminate between returns between unsecured creditors, it would certainly limit the ambit and operation of part 5.3A significantly.[4]

11.10 A number of insolvency practitioners reinforced the importance for DCAs to have the necessary flexibility to enable a company to arrange its affairs so that it is able to continue trading in the interests of all its creditors. Mr Crutchfield maintained that discriminatory deeds were important and should not be prohibited, as the courts have provided guidance as to what is appropriate and what is inappropriate to be included in a DCA under the terms of the legislation.[5] Mr Lopez told the Committee:

> I do not see that there is much to be gained in removing that flexibility because there may be circumstances in which, for the sake of the survival of the company and for the sake of creditors generally, some creditors may accept that.[6]

11.11 While the practitioners agreed that there may be cases where creditors are happy to give up part of their entitlements under a DCA, they noted that certain

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2 *Submission* 14, p. 6.

3 Submission 14, p. 5.

4 *Committee Hansard*, 7 August 2003, pp. 123-24.

5 *Committee Hansard*, 7 August 2003, p. 125; and cf s 445D.

6 *Committee Hansard*, 8 August 2003, p. 174.

conditions should come into play. Firstly, that under the deed, creditors would get a better return than they would under a liquidation. Mr Zwier told the Committee that:

> …if a deed of company arrangement is unfairly prejudicial to a creditor or class of creditors—that is, that creditor or class of creditors would be better off in a liquidation—then the court will overturn the deed of company arrangement. That is one safeguard.[7]

11.12 Two witnesses came before the Committee to explain their particular experiences with what they believed was a discriminatory DCA.

11.13 Ms Elizabeth Fullerton, from the perspective of an employee creditor of a company placed into voluntary administration, expressed concern that a DCA may disrupt the normal distribution priorities set out in s 556 and, in doing so, alter employees' entitlements under GEERS. In her view the rights of employees to their entitlements should not be allowed to be reduced or denied, particularly on a case-by-case basis. She submitted that employee creditors of a particular company should be no less entitled to the full value of their entitlements than employee creditors of any other company. Ms Fullerton also expressed concern that administrators should not be permitted to conduct a creditors' meeting to vote for a DCA if the pertinent information could not be made available to creditors within a reasonable period of time prior to the meeting or if the DCA had not yet been written.[8]

11.14 Mr Nicholas Bishop, also from the perspective of an employee creditor of a company placed into voluntary administration, proposed that:

> The operation of a Deed of Company Arrangement be made much more like a liquidation (with respect to subrogation rights, the priorities of various classes of creditor, and recoveries for insolvent trading and the like) with the primary differences being: The company keeps operating; Payment of 100% of debts (as discussed above) The primary issues to be decided in a Deed would therefore become: The timetable of when creditors are to be paid Whether secured creditors maintain their investment or not; Which assets are to be sold and kept; Business plans.[9]

11.15 As noted earlier, a Court may terminate a deed where it is satisfied that material information was omitted or the deed is oppressive or unfairly prejudicial to one or more creditors. Recourse to the courts, however, requires, both awareness of rights and the wherewithal to fund the action. While, the Law Council considered that the operation and effectiveness of DCAs has worked well, it had one area of concern:

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7 *Committee Hansard*, 7 August 2003, p. 130. See also evidence from Mr Crutchfield, *Committee Hansard*, 7 August 2003, p. 132; Mr Georgakis, *Committee Hansard*, 7 August 2003, p. 94.

8 *Submission* 31, p. 7.

9 *Submission* 36, p. 10.

> An aggrieved creditor has to incur the expense to obtain a court order to set aside a Deed that is 'not in the interests of creditors' and/or entered into only with 'vote stacking' by related entities at the second meeting. There should be a more efficient way to deal with this. Directors and/or promoters of Deeds should be required to provide reasons to ASIC, on the application of an 'interested person' why the Deed should not be set aside. If ASIC is not persuaded by the 'show cause' the onus should then be on the directors and/or promoters to make application to Court seeking a declaration that the Deed is valid and enforceable.[10]

11.16 The Committee accepts that it may be appropriate in some instances for a deed to provide for different treatment of creditors if, for example, the deed has been entered into in accordance with rules of fairness and offers dissenting creditors a better return than they would receive in a liquidation. The broad aim of Part 5.3A is to leave the contents of the deed as flexible as possible to suit the requirements of the particular company's and creditors' circumstances.

11.17 As noted on a number of occasions, the law permits a deed to be terminated where it is found to be oppressive or unfairly prejudicial to, or unfairly discriminatory against, creditors. The Committee considers that the Courts are best placed to determine whether a particular deed is oppressive or unfairly prejudicial to, or unfairly discriminatory against, creditors and to distinguish between proper and improper forms of discrimination in DCAs. It does not consider it appropriate that ASIC determine the appropriateness of the provisions of DCAs.

11.18 The Committee has serious concerns, however, about deeds which seek to alter the priorities of s 556(1) against the wishes of a majority of the affected creditors. The Committee considers that it is implicit in the law as it currently exists that the priority provided for in s 556(1) should generally be followed unless affected creditors agree for possibly any one of a number of reasons to accept a lower return. Crutchfield's *Corporate Voluntary Administration* expressed the following view:

> To avoid creditors who would have a priority in a winding-up from alleging unfair prejudice under s 445D, it could be expected that the priority laid down in s 556 would be generally adhered to, unless the priority creditors indicated that they were prepared to forgo their priority.[11]

11.19 The Committee considers that the law should now put the matter beyond doubt as to the standing of priority creditors under a deed of company arrangement where the deed modifies their priority. The law should make it clear that a deed of company arrangement must preserve the priority of creditors under s 556(1) unless affected creditors agree to waive their priority. While creditors who consider a particular deed is oppressive or unfairly prejudicial or discriminatory have the right to

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10 *Submission* 26, p. 16.

11 *Crutchfield's Corporate Voluntary Administration*, Colin Anderson & David Morrison, Lawbook Co., 3rd edit, Sydney 2003, p. 191.

initiate proceedings in the Supreme Courts or in the Federal Court, this imposes a considerable burden on an applicant, particularly where creditors are not in agreement or willing to contribute to the cost of proceedings. The Committee recognises that the ability to negotiate a deal is at the heart of the voluntary administration process. It does not consider that an amendment along the lines proposed in the following recommendation will unduly restrict the capacity to negotiate a deal.

Recommendation 49

11.20 The Committee recommends that the law be amended to make it mandatory for a deed of company arrangement to preserve the priority available to creditors in a winding up under s 556(1), unless affected creditors agree to waive their priority. The amendment should, however, allow creditors or the administrator the right to initiate court proceedings to have the deed upheld if in the Court's view the deed offered the dissenting creditors a better return than they would obtain in a liquidation.

11.21 The second condition that should apply where a DCA alters the priority arrangement is that creditors should be fully informed about the terms of the DCA and how it would affect them[12] For example, Mr Zwier maintained that reputable practitioners have an obligation to make disclosures—'absolute disclosure of the differences'. Mr Lopez told the Committee:

> A prudent deed administrator would be unwise to support a deed which takes away the rights of creditors without first having those creditors understand what the consequences of that change might be and having their support at the meeting.[13]

11.22 The Committee was surprised to learn from Mr Michael Maynard, DEWR, that although the department advised and requested insolvency practitioners to provide information to creditors voting on a deed about the terms governing the advancement of GEERS funding, they were not under an obligation to do so.[14] Indeed, evidence suggested that unsophisticated creditors are not always fully informed about the contents and effects of a DCA. According to Mr Watts not all insolvency practitioners are conscientious in ensuring that creditors have an adequate understanding of the DCA. He told the Committee that the union is aware of examples 'where employees have been unaware of what in some cases have been complex deeds of company arrangements which have altered the priority arrangements'. He added:

> In fact in many cases they have voted for those deeds of company arrangements, although unbeknown to them there has been a change in

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12 See for example, Mr Zwier, *Committee Hansard*, 7 August 2003, p. 132; Mr Crutchfield, *Committee Hansard*, 7 August 2003, p. 132.

13 *Committee Hansard*, 8 August 2003, p. 175.

14 *Committee Hansard*, 26 June 2003, p. 37.

> priority, because of the complex nature of the documents that have been put before them.[15]

11.23 He was of the view that:

> There should be an obligation—we think primarily on those proposing the deed of company arrangement but also on the administrator or liquidator of a company—to advise all the creditors, including the employee creditors, what the ramifications or implications of the deed of company agreement are. This needs to be done clearly, particularly in cases where employees are from a non-English-speaking background or their involvement in the financial affairs of businesses is such that they are very much taking advice from others as to what is best for the company. In many cases they are voting away certain rights and are clearly unaware that they are doing so. So we think they should be made clearly aware of the implications of a deed of company arrangement if any rights are being removed or preferences altered. If they then make a conscious decision to vote to do so, so be it.[16]

11.24 The Committee fully endorses this viewpoint. One of the persistent themes running throughout this report is the need to assist unsophisticated creditors safeguard their rights.

11.25 The findings of the 1998 Study of Voluntary Administrations in NSW have direct relevance to this matter of the level of understanding that creditors have of the complexities surrounding the formulation and implementation of a DCA. It found that the major defaults in compliance with the terms of DCAs occurred in failing to enforce the terms of deeds rigorously. It noted non-compliance in relation to the receipt of moneys payable pursuant to the DCA on a timely basis, non-compliance in relation to monitoring and reporting requirements to, and by, the administrator, and procedures to be followed in the event of default. It noted the following shortcomings in the manner in which some DCAs are prepared:

- the intentions of creditors expressed at the meeting to decide the company's future are not being reflected in the actual terms of the DCA;
- matters are being included which were not discussed or approved by creditors;
- open ended discretions are being included in the deed which were not discussed or approved by creditors;
- the prescribed provisions were being amended in ways that may not be in the interests of creditors and employees, for example, in relation to the priorities specified in s 556, which had the effect of denying the priority normally accorded to claims by employees; the requirements relating to

15 *Committee Hansard*, 7 August 2003, p. 103.

16 *Committee Hansard*, 7 August 2003, p. 103.

meetings in the event of default; the requirement to have a committee of inspection; the requirement to lodge accounts of receipts and payments with ASIC;

- the terms of DCAs are not being enforced (appropriate action following default is not being taken, moneys payable under the deed are not being received and follow-up action is lacking, monitoring and reporting to, and by the administrator is inadequate);
- DCAs are being varied without giving creditors details of the variation.[17]

11.26 With reference to the issue of recommending a deed that has little chance of success, Anderson and Morrison note that the creditors make the decision about the future of the company. The fact that the deed is recommended does not oblige the creditors to vote for it. They are surely in the best position to evaluate their interests. If there is some failure on the part of the administrator to provide sufficient information then that will be apparent to interested and attentive creditors and armed with this information those creditors will vote accordingly.

11.27 They also note that:

> …it is a common feature of company rescue regimes that 'rescued' companies might fail. This is a chance that the creditors take. We believe that the real issue is the determination of the frequency of failure, the reasons for it and the resulting impact of it, rather than an unproductive focus upon the prevention of (some inevitable) failures of 'rescued' companies.[18]

11.28 The Committee accepts that the law provides for the rights of creditors in the process of formulating a deed of company arrangement and during the period in which the company is subject to a DCA. However, it is necessary to recognise the imbalance in power and sophistication among creditors. Due to a superior level of knowledge and experience of insolvency procedures some creditors are better placed to exercise their rights than others. The Committee believes that the availability of appropriately targeted information can assist in addressing the imbalance between creditors and allow inexperienced creditors to participate actively in insolvency procedures and achieve better overall outcomes for themselves.

Recommendation 50

11.29 The Committee recommends that ASIC work with the IPAA to educate unsophisticated creditors about their rights in the process of formulating a deed

17 Australian Securities Commission Research Paper 98/01 '*A Study of Voluntary Administrations in New South Wales*' 1998, p. 37.

18 *Submission* 34, p 8.

of company arrangement and during the period in which the company is subject to a DCA.

11.30 There is a second prong to this strategy to have better informed creditors who have the knowledge and confidence to assert their rights. The obligation falls not only on ASIC but also on insolvency practitioners who supposedly act in the interests of all creditors.

Recommendation 51

11.31 The Committee recommends that the IPAA take note of the criticism raised about insolvency practitioners and the information they make available to creditors about DCAs. It would like to see the IPAA adopt a strong and active position to ensure that its members take seriously their responsibilities and obligations to inform creditors about all aspects of the DCA.

11.32 The ATO noted that some DCAs proposed the issue of promissory notes to creditors rather than direct payment. Promissory notes may be for a large proportion of creditors' debts. The ATO had two main worries about such deeds. The company's obligations under the deed were completely fulfilled as soon as the promissory notes were issued and regardless of whether or not the notes were ever honoured. Such a deed appeared to subvert the intent of s 450E(2) which requires a company to include the expression 'subject to deed of company arrangement' on its public documents and negotiable instruments. The purported immediate discharge of its obligations under the DCA allows it to avoid this obligation. In the ATO's view a DCA which incorporates any form of promise of future performance should not be construed as finalised until all such promises have been fulfilled.[19] The Committee agrees.

Recommendation 52

11.33 The Committee recommends that the law be amended to clarify that a DCA which incorporates any form of promise of future performance should not be regarded as finalised until all such promises have been fulfilled.

11.34 Deloitte Touche Tohmatsu suggested that there should be a minimum set of monitoring standards that are easy to comply with built into the deed, with severe penalty to parties who obstruct the deed administrator in so monitoring. The degree of compliance would depend on the terms of the deed itself. Some deeds are harder to monitor than others. This could be supported by a requirement for directors of a company under a deed to report annually that the terms of the deed have been complied with and with severe penalties for false reports.[20]

11.35 The Committee's main focus when considering DCAs was on the actual formulation and approval of the deed. It did not examine closely the compliance

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19 *Submission* 14, p. 7.

20 *Submission* 19, p. 4.

aspect. It does, however, note Deloitte's concerns about monitoring compliance and suggests that Treasury and ASIC review this area of compliance with a view to determining whether action is needed. Again the availability of statistics on the nature and level of complaints dealing with non-compliance with a DCA would give an indication of whether further attention should be given to this matter.

11.36 The Committee notes that creditors have opportunities under the law to seek termination of a deed if compliance with its terms are unsatisfactory. The terms of the deed may make provision for appropriate monitoring and reporting on compliance. Complaints in relation to the management of the company during the period in which the company is subject to a DCA are reviewable by the Court under s 447E.

11.37 Unsophisticated creditors may not be aware of actions that are open to them for the purpose of monitoring the fulfilment of terms of DCAs and reporting on compliance. They may also need to consider how a DCA should deal with monitoring and reporting issues in negotiating its terms. The Committee considers that ASIC should work with the IPAA to make available information to assist unsophisticated creditors understand the options open to them for the purpose of monitoring the fulfilment of terms of DCAs and reporting on compliance. The Committee has already expressed its concern about the lack of targeted information about aspects of insolvency procedures for unsophisticated creditors elsewhere in this Report.

Recommendation 53

11.38 The Committee recommends that ASIC work with the IPAA to inform unsophisticated creditors about the options open to them for the purpose of monitoring the fulfilment of terms of DCAs and reporting on compliance.

11.39 This chapter has considered the impact of deeds of company arrangement and measures to enhance the rights of creditors in relation to such deeds. The following concluding chapter considers miscellaneous issues that have been raised in submissions and by witnesses on aspects of insolvency law.

CHAPTER 12

OTHER ISSUES

12.1 The Committee has not been able to review, and test, every issue of concern. Of necessity it has had to be selective and this chapter brings together and reviews particular criticisms of features of insolvency procedures that submissions and witnesses have raised but which the Committee did not examine in depth. Many of these issues have been the subject of consideration elsewhere and recommendations have been made in relation to them. Issues highlighted in submissions and considered here include:

- the creditors' voluntary liquidation procedure;
- a prohibition on the termination of contracts;
- abolition of the peak indebtedness rule;
- liquidator's powers to compromise debts and enter into contracts;
- joint and several appointments of external administrators;
- shareholders of companies in external administration; and
- statutory demands.

12.2 This chapter also addresses a number of strategic issues raised in submissions and/or testimony which do not fall neatly within the Committee's various terms of reference but are of continuing significance for the efficient operation of insolvency law. They include the collection of data on the operation of insolvency laws and the possible merger of corporate and personal insolvency law.

Creditors' Voluntary Liquidation (CVL)

12.3 Directors of insolvent companies or companies in financial difficulty have to consider the options for external administration because they are under a legal obligation to cause an insolvent company to cease trading. If they fail to do so they may be held personally liable for the company's debts. One of the options available to them is to initiate a creditors' voluntary winding up.

12.4 Part 5.5 of the Corporations Act provides for a creditors' voluntary winding up. Under the procedure, the companies' directors call meetings of shareholders and creditors. The shareholders may pass a special resolution to wind up the company and nominate a person to act as liquidator. It is also necessary to convene a meeting of the company's creditors which is to be held on the same day or the day after the shareholders meet. The creditors may nominate a person to act as liquidator instead of the person nominated by the shareholders. The company's directors must prepare a

report on the affairs of the company and table it at the creditors' meeting. A corporation may also enter a creditors' voluntary winding up directly from voluntary administration and, in those circumstances, the administrator or deed administrator is deemed to be nominated as the liquidator for the purposes of the winding up.

12.5 Several submissions suggested that the CVL procedure is unsatisfactory in its present form and should be revised.[1] Mr Paul Gidley, an official liquidator, considered that the procedures to enter CVL do not embody contemporary insolvency principles, in particular the principle that insolvency laws should provide mechanisms that enable both the debtor and creditor to participate with the least possible delay and expense, and the principle that an insolvency administration should be impartial, efficient and expeditious.[2] Because of the time lag between a determination that a company is insolvent and the commencement of the voluntary liquidation, directors and creditors face a number of risks. These include the opportunity for antecedent transactions to occur, ongoing trading resulting in further losses to creditors and exposing directors to insolvent trading or other personal liability, the dissipation of company property and a pre-liquidation 'grab for cash' by stakeholders, leaving the liquidator with complex and expensive asset recovery issues.[3]

12.6 In Mr Gidley's view, amending the CVL procedure to allow directors to enter directly into liquidation would:

- resolve the timing inequity in the CVL process created by the interaction between director penalty notices issued under the Income Tax Assessment Act & Payroll Tax Act ;
- eliminate or at least reduce the abuse of the Part 5.3A process, bringing impartiality once again to the process of selecting the most suitable form of external administration for officers to comply with their fiduciary and statutory duties;
- improve the efficiency of the CVL process, by reducing costs and reducing the risk that creditors and other key stakeholders may suffer further losses;
- provide another means for directors to improve corporate governance, by providing a swift and cost effective means to deal with terminal insolvency issues; and
- safeguard assets during the hiatus period.[4]

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1 *Submission* 12, pp. 3-4, *Submission* 22A, pp. 10-11; *Submission* 23, pp. 7-8; *Submission* 50; *Submission* 54, p. 4.

2 *Submission* 50, pp. 2-3.

3 *Submission* 50, p. 7.

4 *Submission* 50, p. 3.

12.7 Mr Gidley also noted that it is arguably unclear whether the initiation of a CVL constitutes an adequate defence to a contravention of the insolvent trading provisions under s 588H(5).

12.8 Some submissions expressed the view that the VA procedure is open to misuse in that it (rather than the CVL procedure) is being used as a means for placing a company into liquidation rather than as a means of enabling a company to continue in existence. Some of the points made included:

- some administrators are recommending deeds of company arrangement (DCA) that have little or no chance of succeeding—a liquidation is inevitable;
- recommendations are made after an inadequate assessment of the history and viability of the company's business;
- creditors who extend credit to the company during the DCA face a risk of losses—the delay makes it difficult to pursue recovery actions;
- a deed administration followed by a liquidation may be more expensive and leave less for creditors than a straight liquidation;
- penalty notices issued to directors for outstanding taxes under s 222AOE of *the Income Tax Assessment Act 1936* make directors personally liable unless they either pay the outstanding amounts or put the company into administration or liquidation within 14 days. Placing a company into liquidation takes too long as it requires consultation with shareholders and creditors if it is insolvent.

12.9 Mr D'Aloia commented:

> Many companies are placed into voluntary administration as a fast track to liquidation. In these cases, there is no desire or ability to propose a Deed of Company Arrangement and in many cases the business has long since been sold or closed down.[5]

12.10 He recommended that it should be as quick and as easy to put a company into a creditors' voluntary liquidation as it is to put a company into voluntary administration.[6]

12.11 Ernst & Young also suggested that the creditors' voluntary liquidation process should be simplified to enable directors to place a company immediately into liquidation. The appointment should be confirmed or the liquidator replaced at a

5 *Submission* 15, p. 1.

6 *Submission* 15, p. 1.

meeting of creditors within 14 days.[7] This issue was further elaborated on in submissions of other commentators.[8] The IPAA was also critical of the CVL procedure:

> …if the directors wish to place a company directly into Creditors' Voluntary Liquidation there is a delay of between one and three weeks from when the decision is made by the directors to when the meeting of members is held to pass the resolution appointing the liquidator. During this period, if the Directors continue to trade the business, they run the risk of insolvent trading, assets can be eroded by the actions of creditors seeking to recover monies, assets may be uninsured as there may be no funds available to meet insurance costs and landlords may take action to evict the company if rent is unpaid. Placing a company into the hands of an external administrator via Voluntary Administration can be done immediately.[9]

12.12 The IPAA suggested a different solution. It proposed that the VA legislation be amended so that, with the administrator's consent, creditors can resolve to place a company into liquidation at the first meeting of creditors. It also recommended that if creditors resolve to place the company into liquidation, they should also have the power to choose their own liquidator. The IPAA argued that this method had the following advantages:

- a fast and efficient commencement to a form of external administration;
- a viable choice for directors when they are served with a s 22AOE notice by the ATO;
- avoidance of the cost of holding two meetings, possibly resulting in a better return to creditors;
- not having to wait until the second meeting of creditors in a voluntary administration to place the company into liquidation when it is obvious to the administrator that liquidation is the only alternative.[10]

12.13 The question of the status of the CVL procedure vis-à-vis the VA procedure has been the subject of consideration by both the Harmer Report and the Advisory Committee. The Harmer Report (in contrast to the above submissions) recommended that the creditors' voluntary liquidation procedure should be abandoned.[11] It considered that the procedure was unsatisfactory for two reasons: it provided no

7 *Submission* 21, pp. 1-2.

8 *Submission* 12, pp. 3-4, *Submission* 22A, pp. 10-11; *Submission* 23, pp. 7-8; *Submission* 50, p. 16.

9 *Submission* 22A, p. 10.

10 *Submission* 22A, p. 11.

11 ALRC Report no. 45, vol. 1, para.57.

ordered administration between the time of calling the meeting of creditors and the appointment of a liquidator; and creditors did not have access to independent information about the company's affairs at their meeting.[12] The Advisory Committee also recommended that the creditors' voluntary liquidation procedure be abolished.[13]

12.14 Neither of these recommendations has been implemented. The CVL procedure continues to be a feature of the law. After voluntary administrations and official liquidations, CVLs are the most commonly used insolvency procedure. In 2003 there were 1,268 such procedures, representing 19 per cent of total external administrations.

12.15 A number of practitioner submissions referred to cost disadvantages in the case of liquidation via a VA. Mr Gidley noted the differences between obligatory and discretionary investigation and reporting obligations in the VA and CVL procedures.

12.16 In assessing the costs associated with a liquidation via a voluntary administration, it is necessary to consider the premature liquidation of companies as well as the re-organisation of companies that would be better off being liquidated. If a company is forced prematurely into liquidation there is generally no evidence that this has occurred.[14] The following quote by Anderson and Morrison was noted earlier:

> It is a common feature of company rescue regimes that 'rescued' companies might fail. This is a chance that the creditors take...the real issue is the determination of the frequency of failure, the reasons for it and the resulting impact of it, rather than an unproductive focus upon the prevention of (some inevitable) failures of 'rescued' companies.[15]

12.17 They make the further point that:

> …directors may be very reluctant to take action to deal with insolvency where a court procedure is involved or liquidation is a certain outcome. The additional delay may in fact cause greater losses than a procedure such as Part 5.3A that encourages quick response to the company's difficulties. Even if these losses are greater in an individual case, consideration must be given to the social benefits gained for those companies that do succeed.[16]

12.18 Mr Georgakis, who also expressed concern at the limited means of placing a company into liquidation, commented on the question of the relative costs:

> In a VA, there are two creditors' meetings that need to be held within 21 days. In the creditors' voluntary administration you would still need to hold

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12 ALRC Report no 45, vol 1, para 49.

13 Recommendation 56.

14 *Submission* 34, p. 9.

15 *Submission* 34, p. 8.

16 *Submission* 34, p. 8.

> the first creditors' meeting but whether you would need to hold any subsequent creditors' meetings would depend on the findings of the investigations and a variety of other issues. Also, by putting the company immediately into a liquidation sense, it potentially stops the bleeding. It stops the losses being incurred and potentially takes away the risk of assets being dissipated further during that lag. They are the sorts of things that we were thinking of. They are the benefits in a sense as well, and it happens much quicker.[17]

12.19 Mr Zwier suggested that easier entry to the CVL procedure would help to address the problem of phoenix companies:

> Phoenix companies really require conduct which borders on dishonesty. If directors cannot invoke the provisions lawfully, because the company is insolvent, an insolvency practitioner might say: 'I can't sign a consent to act here, because you do not have a proper power to put this company into voluntary administration. Your only choice is to liquidate it. You can liquidate the company either by application to the court or by other processes which are quite different.' Reputable practitioners would have a role to play in ensuring that Part 5.3A is not invoked when a company is hopelessly insolvent.[18]

12.20 The view that it is not an abuse of Part 5.3A to put a company into administration when it is clear that the company cannot be saved from liquidation is supported by judicial authority. In Dallinger v Halch Holdings Pty Ltd[19] Sundberg J said:

> The machinery provided by the Part should be available in a case where, although it is not possible for the company to continue in existence, an administration is likely to result in a better return for creditors than would be the case with an immediate winding-up.

However, Crutchfield's *Corporate Voluntary Administration* notes the following qualification:

> Comments by Sundberg J in *Dallinger* do, however, sound a note of caution for those proposing to use the voluntary administration procedure where the company has no possibility of continuing in existence and the directors have not formed a reasonable view that administration would provide a better return to creditors than a liquidation, or is otherwise in the interest of creditors. His Honour appeared to accept in argument that where the appointing directors have a purpose in making the appointment other than the purpose of seeking to improve the position of the company or its

17 *Committee Hansard*, 7 August 2003, p. .91.

18 *Committee Hansard*, 7 August 2003, p. 129.

19 (1996) 14 ACLC 263.

creditors, an order may be made under s 447A terminating the administration.[20]

12.21 The Committee notes the strong representations from many insolvency practitioners in support of modifications to the CVL procedure. It recommends that the CVL procedure be retained and simplified to enable directors to place a company into liquidation immediately.

12.22 The Committee does not consider that creditors should be able to resolve to place a company into liquidation at the first meeting of creditors under the voluntary administration procedure. It agrees with Mr Crutchfield who expressed a preference for a disconnect between administration and liquidation.[21] The first meeting may not be well attended or be representative of the general body of creditors.

Recommendation 54

12.23 The Committee recommends that the creditors' voluntary liquidation procedure should be retained and entry to the procedure simplified to enable directors to place a company immediately into liquidation. Where an enterprise is not viable, the law should allow for its swift and efficient liquidation to maximise recoveries for the benefit of creditors.

Prohibition on the termination of contracts

12.24 Many contracts that companies enter into include clauses—'ipso facto' clauses—that give the other party to the contract the right to terminate the contract 'by the mere fact' of the other party's insolvency, if the other party becomes subject to a form of external administration or financially distressed or if it fails to maintain a contractually specified financial condition. Such clauses permit termination of the agreement simply because of the other party's financial difficulties.[22] The insolvency laws of some countries override these clauses, so that, if the party cancels, it is liable in damages to the insolvent.

12.25 The IPAA argued that in an insolvency scenario such a clause, if part of a contract that is fundamental to the company's ongoing operation, can result in the external administrator losing the only asset of value to the company—its business—or alternatively place the external administrator in a 'no win' situation when he/she is trying to negotiate the terms of the contract. The administrator may seek injunctive relief in the Courts but this is both expensive and time consuming.

12.26 The Business Turnaround Association commented:

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20 Crutchfield's *Corporate Voluntary Administration*, p. 53.

21 *Committee Hansard*, 7 August 2003, p.127.

22 Material adverse change clauses in finance documentation permit financiers to exit contracts in circumstances short of insolvency. See Karlsson, Katrina, Material adverse change clauses, (2000) 17(9) BLB.

> If companies go into a formal insolvency scheme such as provisional liquidation, liquidation, receivership or even voluntary administration it is generally accepted amongst the insolvency profession that these legislative insolvency schemes themselves destroy value in the companies. This is not through any fault of the Insolvency Practitioner. One of the major problems causing the destruction of value is that existing contracts, which benefit the company, can generally be terminated and many extra liabilities become due when the company commits an event of default. This is typically defined to include the appointment of an Insolvency Practitioner or Voluntary Administrator.[23]

12.27 The IPAA proposed that the law should be amended so that the other party to a contract (other than a charge) would be unable to terminate or modify the contract or repossess any property to which the contract relates without the consent of the administrator or the court.[24] The IPAA proposed further that in order to protect the other party to the contract, if the administrator chooses to continue with the contract, he or she should be liable to pay for that portion of the contract where benefit is obtained during the term of the voluntary administration, similarly to s 443B.

12.28 The IPAA also noted that:

- the Harmer Report recommended that any contractual provision (other than a charge) in the nature of an ipso facto clause be void as against a liquidator or administrator; and
- there is a similar provision in the Bankruptcy Act (s 301 Bankruptcy Act).

12.29 The Advisory Committee considered this issue and recommended that there should be no additional restriction on contractual provisions which enable a party dealing with a company to take certain action merely because the company appoints an administrator. The IPAA stated that it did not agree with this recommendation, as Part 5.3A already places significant restrictions on the rights of creditors (owners and lessors) in order to achieve the objectives of Part 5.3A. Since the Advisory Committee's report there have been many large insolvency administrations where termination of contracts has resulted in inequities to the general body of creditors. In the IPAA's view the changing environment means the issue needs to be reconsidered.[25]

12.30 The Committee accepts that a prohibition on solvent parties terminating contracts pursuant to ipso facto clauses would assist administrations. It is desirable to keep the business intact so that it can be transferred to a potential purchaser with minimal disruption or to enable it to continue to trade. The Committee, however, must weigh up these considerations against the impact such a prohibition would have on

23 *Submission* 18A, p. 2.

24 *Submission* 22A, p. 4.

25 *Submission* 22A, p. 5.

solvent parties. A broad provision of the kind proposed by the IPAA would place too great and too unpredictable a restriction on the contractual rights of parties and introduce considerable complexity and extra economic costs into commercial dealings. It would represent an erosion of the principle of freedom of contract.

12.31 Modern commercial life is honeycombed with the contract—not merely the ordinary contract of sale, but leases and charters, in insurance, in swaps and derivatives, in contracts for the sale of securities or foreign exchange, in transportation and construction, in obligations to lend money or to subscribe for securities and in licences in relation to all types of property present and future. An insolvent party could be on either side of a contract, e.g. buyer or seller, lessor or lessee, constructor or employer, licensor or licensee. It is reasonable for businesses to take steps (or to be free to take steps) to avoid involvement in the financial affairs of failed enterprises. To compel a party to continue to trade with an insolvent enterprise at a risk of further possible loss may place undue emphasis on rescue at the expense of third parties. It is arguable that the presence of ipso facto clauses in contracts may improve managers' incentive to take steps to avoid financial difficulty.

12.32 The Committee notes also that the approach taken by comparable countries to a freeze on contract cancellations has been relatively cautious, aside from the special cases of real property leases and utility services. A few countries have adopted the prohibition, e.g. the US, France and Canada, but it is not a general feature of rescue regimes. In some instances, such as the US, there are very extensive carve-outs.[26]

12.33 The Committee considers that it would be more appropriate for a court to consider whether, in a particular situation, contracts should be kept on foot.

Recommendation 55

12.34 The Committee recommends that the law be amended so as to permit administrators to apply to a court for an order that a party to a contract may not terminate the contract by virtue of entry by a company into voluntary administration. The court should be satisfied that the contracting party's interests will be adequately protected.

Abolition of the peak indebtedness rule in relation to running accounts.

12.35 The Australian Credit Forum (ACF) and the NSW Division of the Australian Institute of Credit Management proposed that the peak indebtedness rule (which is a feature of the law concerning the recovery of voidable transactions and the running account exception to the liquidator's right of recovery contained in s 588FA(3)) should be repealed.[27]

26 Section 362 US Bankruptcy Code.

27 *Submission* 53, p 3; *Submission* 54, p. 3.

12.36 The ACF and the NSW Division submitted that the rule was 'contrary to the principle of equal treatment' (parri passu) which underpins all avoidance provisions. It also undermines the principle affirmed by the High Court in Civil Aviation Authority vs Ferrier that it should be the ultimate effect of the series of transactions which determines whether there has been a preference.

12.37 It also fails to take into account the wording of section 588FA, which requires the transactions in the period of the running account to be treated as a single transaction.[28]

12.38 The peak indebtedness rule may be traced back to the decision of the High Court in Rees v Bank of NSW (1964) 111 CLR 211 where Barwick CJ said at 221:

> It was also said in argument for the bank that it was not permissible for the liquidator to choose a date within the period of six months and to make a comparison of the state of the overdrawn account at that date and its state at the date of the commencement of the winding up. It was submitted that the proper comparison was between the debt in the account at the commencement of the statutory period of six months and the debit at the commencement of the liquidation—a comparison which in this case would result in a materially lesser figure than that reached by taking the liquidator's comparison. In my opinion the liquidator can choose any point during the statutory period in his endeavour to show that from that point on there was a preferential payment and I see no reason why he should not choose, as he did here, the point of the peak indebtedness of the account during the six months period.

12.39 The ACF and the NSW Division set out a number of scenarios of running accounts which, in their view, demonstrated that the rule was manifestly unfair.

12.40 The peak indebtedness rule is a long standing rule of high authority. It is arguable whether it is inconsistent with the principle affirmed in Airservices Australia vs Ferrier.[29] The application of the rule is a matter for the courts to consider as a matter of statutory interpretation. The Committee makes no recommendation about the rule but draws it to the attention of the Treasury. It considers that the appropriateness of the peak indebtedness rule warrants consideration as a feature of the law on voidable transactions. Where two large enterprises have been trading with each other on a running account basis over a period of time, quite large sums of money can be at issue.

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28 *Submission* 53, p. 3.

29 185 CLR 483 and see also Re Weiss; Ex parte White v John Vicars & Co Ltd [1970] ALR 654 at 661; Olifent v Australian Wine Industries Pty Ltd (1996) 19 ACSR 285 at 290.

Compromising debts and entering into contracts

12.41 Under ss 477(2A) and (2B) of the Corporations Act liquidators are required to obtain creditor approval to compromise debts to the company of amounts greater than $20,000 and to enter into an agreement of longer than three months duration.

12.42 The IPAA considers that these restrictions should be removed for the following reasons:

- $20,000 is a relatively small sum of money and compromises of debts over this value would be reasonably common;
- when attempting to negotiate settlement of a debt, it is neither timely nor cost effective for a liquidator to call a meeting of creditors to obtain the necessary approval; and
- a liquidator only has the power to carry on the business of the company so far as is necessary for the beneficial disposal or winding up of that business—a further restriction on agreements over three months is unnecessary.

It added that these restrictions are not imposed on a Trustee in Bankruptcy under s 134 of the Bankruptcy Act.

12.43 Sections 477(2A) and (2B) were included in the amendments to the law implementing the Harmer Report in 1992. They represent an expansion of the powers exercisable by a liquidator under previous laws. Under the previous law, approval had to be sought for the payment of any class of creditors in full, the making of any compromises or arrangements with creditors and compromising any call, liabilities to calls, debts, liabilities capable of resulting in debts and any claims between the company and a contributory or other debtor or person. The explanatory memorandum to *the Corporate Law Reform Act 1992* explained these changes to s 477:

> This expansion of the liquidator's powers to act without prior approval was recommended on the basis of the general competence and qualifications of persons who act in the capacity of liquidator. The Harmer Report was, however, of the view that the continued fetter on the liquidator's powers to compromise debts due to the company where the debt exceeds $20,000 was appropriate, since the compromise of debts is an action which may directly prejudice creditors and where proof of damage to them would be exceedingly difficult after the event. The second fetter recommended by the Harmer Report, namely on the power of entry into long-term commitments such as mortgages, charges or leases, was recommended on the grounds that the unfettered exercise of the power may not be conducive to an expeditious and beneficial administration.[30]

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30 Explanatory memorandum, para. 759.

12.44 The Committee considers that compromises of debts to the company in respect of amounts greater than $20,000, and decisions to enter into agreements of longer than three months duration are matters in which creditors may have a proper interest. The Committee does not recommend that ss 477(2A) and (2B) be amended. The threshold amount of $20,000 may warrant some increase given the inflation of monetary values since the Harmer Report (1988). However, there is a power to prescribe an amount greater than $20,000.

Recommendation 56

12.45 The Committee recommends that the Government review the appropriateness of the restriction on a liquidator's powers to compromise debts due to the company where the debt exceeds $20,000.

Joint and several appointments of external administrators

12.46 Mr Walker and Mr Moller's joint submission outlined a quite specific problem of insolvency law relating to the practice of appointing two or more administrators or liquidators or receivers.[31] External administrators may be appointed 'jointly' or 'jointly and severally'. A 'joint' appointment means that the appointees must concur in every decision and every act in the administration. A 'joint and several' appointment means that the appointees can make decisions or act either jointly or individually (without the other's concurrence).

12.47 Mr Moller commented:

> …the subject of our submission, namely the joint and several appointment of liquidators and receivers, is an important one and has in recent years given rise to not insignificant uncertainty and litigation…It has long been the practice for accounting firms and insolvency practitioners to take joint and several appointments on insolvency engagements. Essentially, a joint and several appointment is one in which two or more insolvency practitioners take office and are entitled to exercise their powers jointly and severally—that is, together or individually. A joint and several appointment offers considerable advantages in terms of convenience and expedition in the conduct of an insolvency regime.[32]

12.48 In complex administrations it is far more convenient for administrators and liquidators to be able to exercise their powers jointly and severally. Sections 451A and 451B concerning the appointment of two or more administrators provide that, where there are two or more administrators of a company, their functions or powers may be exercised by any one of them or by all of them together subject to the instrument or resolution appointing them providing otherwise.

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31 *Submission* 43.

32 *Committee Hansard*, 7 August 2003, pp. 106-07.

12.49 The recent decision of the South Australian Supreme Court in *Harvey v Burfield*[33] suggests that, where the powers of multiple liquidators have not been determined at the time of their appointment, they are appointed 'jointly' and not 'jointly and severally'.

12.50 Mr Walker and Mr Moller propose that s 506(4) be repealed and replaced with a provision that is in similar terms to ss 451A and 451B; i.e. where more than one receiver or liquidator is appointed, their functions or powers should be able to be exercised by any one of them subject to the resolution or instrument appointing them providing otherwise. They also propose that new provisions be included in Parts 5.2 and 5.6 of the *Corporations Act* (which deal with receiverships and windings-up generally) to clarify that, where more than one receiver or liquidator is appointed, their functions or powers can be exercised by any one of them, subject to the resolution or instrument appointing them providing otherwise.

12.51 The authors argue that these amendments would: ensure consistency between receiverships, liquidations, administrations and administrations of deeds of company arrangement; provide clarity as to the practice of joint and several appointments; and make for more efficient administrations.

12.52 The Committee agrees that it is more convenient and efficient for multiple external administrators to be able to act 'jointly and severally' and that the provisions of the Act dealing with multiple appointments should be consistent.

Recommendation 57

12.53 The Committee recommends that consideration be given to repealing s 506(4) and replacing it with a provision in similar terms to ss 451A and 451B (concerning the appointment of two or more administrators) i.e. where more than one liquidator is appointed, their functions or powers should be able to be exercised by any one of them, subject to the resolution or instrument appointing them providing otherwise. Consideration should also be given to similar provisions being included in Parts 5.2 and 5.6 of the Corporations Act dealing with receiverships and windings-up generally.

Statutory Demands

12.54 A statutory demand is a formalised demand for payment served by a creditor on a debtor company in certain circumstances governed by the Corporations Act. The purpose of a statutory demand is to establish the circumstances in which a creditor serving a demand can rely on the company's failure to comply with the demand or successfully have it set aside to establish the insolvency in an application to wind up. It is the most commonly used means for initiating a winding up.

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33 (2002) 82 SASR 11.

12.55 The Corporations Act permits a person who is owed money by a company to serve that company with a formalised written 'statutory demand' for payment. The statutory demand procedure is one way of establishing that a company is insolvent and should be wound up. The significance of a statutory demand is that if a company fails to comply with a validly served statutory demand, there is a presumption that it cannot pay its debts as and when they fall due. However, this presumption can be rebutted by a debtor company.

12.56 Few submissions commented on the law relating to statutory demands. Professor Andrew Keay raised a range of concerns about the statutory demand procedure, including that—the law is technical and gives rise to substantial litigation; it does not discourage or prevent insolvent companies from continuing to trade; it is inflexible and harsh in its consequences; and it may be used unfairly against solvent companies. He commented:

> …the procedure and scheme that has been set up has caused certain problems in that a huge number of cases have been heard since 1993. There has been a stream of cases since this year. I would imagine that this is the area that has attracted the most litigation since 1992 and it has produced a rather tangled mass of case law.[34]

12.57 He proposed two means for addressing problems generated by the statutory demand procedure. Firstly, the adoption of the procedure in personal bankruptcy which requires a judgment to be obtained before the issue of a bankruptcy notice. He observed:

> If you have the judgment of a court already, it is very difficult for the debtor to argue that there is no debt.[35]

12.58 Secondly, he proposed that courts be given powers to make directors liable for the costs of proceedings where their companies clearly do not have a genuine dispute and are just trying to raise defences as a way of putting the creditor off taking up the winding-up proceedings.

12.59 Given that the law relating to statutory demands is such a central aspect of insolvency law and generates many complaints and litigation, the Committee considers that it would be appropriate to review the operation of the law after a decade of use of statutory demands. The Committee makes no specific recommendations about amendment of the provisions governing the statutory demand procedure. However, it considers that in any CLERP review of insolvency law the statutory demand provisions should be included by Treasury, both to review the underlying policy and remove any technical anomalies that may have emerged from the case law, with a view to reducing the incidence of wasteful litigation.

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34 *Committee Hansard*, 14 August 2003, p. 212.

35 *Committee Hansard*, 14 August 2003, p. 212.

Shareholders of companies in external administration

12.60 One submission highlighted the need to consider the impact of corporate insolvencies on shareholders.[36] It noted that a shareholder's most important residual interest is almost invariably the crystallisation of a capital loss for tax purposes.[37] Under s 104-145 of *the Income Tax Assessment Act 1997*, a liquidator may make a declaration that there is no likelihood that the shareholders in the company will receive any further distribution in the winding up.

12.61 Some concerns have arisen in regard to this provision. Considerable time may elapse before a liquidator is able to make such a declaration. The power to make a declaration appears to be available only in the case of a liquidation. It would not be available in the case of a voluntary administration.

12.62 The Committee did not take evidence in relation to this issue. However, it notes that the external administration of Pasminco took the form of a voluntary administration which did not permit a declaration to be made, even though it was allegedly reasonably clear that shareholders would not receive a distribution. It considers that an administrator of a deed of company arrangement should be able to make a declaration that there is no likelihood that shareholders in the company will receive any further distribution for the purpose of s 104-145 of the *Income Tax Assessment Act 1997*.

12.63 The Government has announced its intention to legislate to allow any insolvency practitioner to declare shares and other securities in a company to be worthless for CGT purposes.[38] The Committee does not consider that 'any insolvency practitioner' should have this right. The Committee envisages circumstances where this authority should not apply. For example, an administrator (as opposed to an administrator of a deed of company arrangement) will only have a limited opportunity to appraise the financial position of the company given the time constraints that an administrator is subject to. Also some receivers are appointed for strictly limited purposes. There is also the case of a receiver of a single piece of property which forms a small part of a company's property who will not be administering the company. In these circumstances the right to make the relevant declaration should be restricted to managing controllers who have taken control or possession of the whole, or substantially the whole of the corporation's property.[39]

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36 *Submission* 5, p. 1.

37 *Submission* 5, p. 2.

38 Media Release, Senator Connan, 'Capital Gains Tax Improvements', 11 May 2004, C029/04.

39 Managing controller is defined in section 9. A managing controller is distinct from a receiver who may have power to realise property but not power to manage the company pending sale.

Data on operation of insolvency laws

12.64 In the course of its Inquiry into Australia's insolvency laws, the Committee has become aware of the paucity of contemporary systematic comparative information and empirical data on the operation of corporate insolvency laws and, especially, on the operation of the most commonly utilised procedure, the voluntary administration procedure. In contrast, the Insolvency and Trustee Service Australia (ITSA) publishes a range of systematic comparative information in its annual Report on the Operation of the *Bankruptcy Act* 1966.

12.65 There is, for example, no or very limited information about the outcomes for companies entering voluntary administration or typical returns to different types of creditors under VAs/DCAs as compared with liquidations. Similarly there is scant data on the outcomes of s 439A(2) meetings, the direct costs (legal and professional) of voluntary administrations, the experiences of companies entering DCAs, the point in their path of decline that companies enter an insolvency procedure, the levels of gross recoveries under different procedures, or the impact of voluntary administrations on creditors, employees and shareholders. Commissioned studies such as the 1998 Australian Securities Commission research paper, *A Study of Voluntary Administrations in NSW,* have the potential to enhance the level of insight into the impact of corporate insolvencies and assist in evaluation.

12.66 The EXAD project noted in chapter 10 has been in operation since June 2002 and aims to promote and facilitate the lodgement of forms electronically by external administrators, although lodgement in paper form will still be accepted. The electronic lodgement of documents allows ASIC to provide a prompt response to the information contained in reports, and to efficiently collate and publish statistical information on external administrations.

12.67 In particular, ASIC will use Schedule B reports (reports under sections 422, 438D and 533 of the Corporations Act) to compile statistical information in an aggregated and anonymous form. This information will be available to Government, the profession and other relevant stakeholders.

12.68 In order to facilitate the compilation of this statistical information, Practice Note 50 requests that, wherever possible, practitioners lodge Schedule B reports within two months of appointment.

12.69 The Committee considers that there is considerable scope to improve the level and quality of empirical data available on the operation of corporate insolvency laws. Such data has the potential to assist in the most effective allocation of resources, the making of judgements about the targeting of law reform and in the identification of additional information that should be acquired.

12.70 The Committee considers that there is a need for a program of research into the impact of insolvency procedures. If necessary, there should be a specific allocation of funding for the conduct of such research by ASIC, the professional associations or commissioned researchers.

12.71 The Committee considers that the EXAD project has the potential to enhance the range and quality of information about the operation of corporate insolvency laws. It supports ASIC's promotion of more efficient insolvency reporting through EXAD. It considers that the law should specifically authorise the collection of statistical data by ASIC in forms approved by it, pursuant to s 350.

Recommendation 58

12.72 The Committee recommends that the Government support a program of research into the impact of insolvency procedures, if necessary, by providing a specific allocation for the conduct of such research by ASIC, the professional associations and/or commissioned researchers.

The Committee recommends that the law should authorise the collection of statistical data by ASIC in forms approved by it pursuant to s 350.

Merger of corporate and personal insolvency law

12.73 The question of the merger of corporate and personal insolvency law has been considered by various bodies over the years. The Harmer Report recognised that there were advantages in having unified legislation but did not go so far as to recommend a merger regarding other reforms as more important. The former Trade Practices Commission in its 1992 Study of the Professions recommended that consideration be given to the issue. The 1997 Review of the Regulation of Corporate Insolvency Practitioners made a qualified recommendation that the Government examine the benefits of a merged regulatory framework for personal and corporate insolvency.

12.74 Some submissions and witnesses supported a merger of corporate and personal insolvency law. Professor Keay has noted six advantages of a unified scheme:

- many aspects of insolvency affecting individuals and companies are, or should be, the same as the aims of personal and corporate insolvency;
- there are potential savings in a unified scheme;
- law reform bodies such as the Harmer and Cork Committees have emphasised the need for harmony;
- a dual system poses difficulties for members of the public;
- insolvency law is a distinct field of law, not a part of company or commercial law;
- it is desirable for insolvency law to be controlled by the one government department.

12.75 Before the Committee, Professor Keay acknowledged that there would be difficulties in achieving unitary legislation, but commented:

> I think it is preferable to have a single system, because it fosters harmony rather than divergence. I think we have divergence with the bankruptcy and the liquidation systems, for example, when they are really very similar.[40]

12.76 Mr Harmer gave the following reasons in support of uniform law:

> First, there are a sufficient number of fundamental concepts of insolvency that are common to both the corporate arena and the personal arena. It seems absurd to have two separate acts—two separate pieces of legislation—directed at precisely the same thing…Secondly, it would enable areas in which there has been, up to now, some different treatment to be made uniform, in particular in the area of the avoidance of antecedent transactions. Thirdly, one of the more important points relates to those who administer insolvency matters, both privately and in the public sector. We have never had in the corporate sector anything like the office of the official trustee, public trustee or whatever you would like to call it. If we had a uniform act, then it may be that the problem of the 'assetless' company could be solved by having the office of the official trustee, or whatever name it is given, able to handle, investigate and report on those cases. From the point of view of the public office administration of insolvencies, be they corporate or individual, I think there is again a strong argument for uniformity. [41]

12.77 Professor Mason also favoured looking at a unified Act, noting that it is a feature of the law of the United Kingdom and the United States.[42]

12.78 Some submissions and witnesses opposed a merger of corporate and personal insolvency law. The Australian Credit Forum and the NSW Division of the Australian Institute of Credit Management supported leaving the regimes separate.[43] The NSW Division pointed to difficulties raised in the Insolvency Issues Paper, namely that the task of drafting unified legislation would be a significant and resource intensive exercise and that a 'merger' may take different forms. Commissioner Collier indicated that the current separate structure for personal insolvency posed no difficulties in practice and there were no calls for the systems to be merged:

> …as part of our stakeholder activities in ASIC, we conduct regional liaison community meetings with the insolvency practitioners three times a year around Australia. We also conduct regular liaison meetings with the IPAA, and this has not been raised as an issue at all in recent times, to my knowledge.[44]

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40 *Committee Hansard*, 14 August 2003, p. 213.

41 *Committee Hansard*, 17 September 2003, p. 279.

42 *Committee Hansard*, 23 May 2003, p. 11.

43 *Submission* 53, p 4; *Submission* 54, p. 5.

44 *Committee Hansard*, 20 August 2003, p. 254.

12.79 A ‘merger’ may, of course, take different forms. A ‘minimalist’ merger may, for example, focus on particular aspects of corporate and personal insolvency law such as a single system for registration and regulation of insolvency practitioners. A ‘maximalist’ merger of the kind envisaged by the Cork Committee in the United Kingdom would represent a major undertaking and the benefits of such an undertaking would need to be demonstrated. The task of drafting unified legislation would be a significant and resource intensive exercise.

12.80 Administrative arrangements for insolvency reflect the different historical evolution of personal and corporate insolvency systems and Commonwealth/State arrangements for corporate law. The Australian Securities and Investments Commission and the Insolvency and Trustee Service Australia have separate responsibilities for the regulation and administration of the corporate and personal insolvency regimes.

12.81 The Committee appreciates that there are persuasive arguments for retaining the current separation of corporate and personal insolvency. There are obvious differences between natural and corporate persons that the law had to take into account. Also, there is no pressing need to undertake a merger and such a merger would in any event be a protracted and difficult exercise, given the tradition of separate insolvency laws in Australia and the terms of the Constitution. Corporate insolvency law is arguably an integral feature of corporate law and the demarcation between personal and corporate insolvency unclear. A unified personal and corporate insolvency law may in fact serve to fragment corporate law.

12.82 On the other hand, the Committee understands that the separation of corporate and personal insolvency law is a result of historical evolution of the law rather than a development based on logic or policy, legal or drafting reasons. A merger of the two systems could produce public benefits including cost savings, a single system for the registration of practitioners and greater consistency in the law and the formulation of policies. There are successful merged systems in other countries, in particular the United Kingdom and the United States.

12.83 The Committee notes the support of witnesses for a merger and previous recommendations of other inquiries suggesting that the merits of a unified legislative and administrative framework for corporate and personal insolvency are worth examining. It considers that a possible merger of corporate and personal insolvency law should remain an option for governments to consider. In the absence of any concrete proposal for a merger of corporate and personal insolvency law, the Committee makes no firm recommendation but is conscious of the importance for the Government to ensure that any future reform in either system is developed and implemented with a view to maintaining compatibility between them.

Recommendation 59

12.84 The Committee recommends that the Government ensure, particularly when contemplating changes to the law, that the two streams of Australia's insolvency laws, personal bankruptcy and corporate insolvency, harmonise where possible.

CHAPTER 13

CROSS-BORDER INSOLVENCY

Cross-border Insolvency

13.1 Cross-border insolvencies occur when a business enterprise operating in more than one country is placed into external administration. The problems and complexities that can arise in the case of a cross-border insolvency can be far more daunting and protracted than those that arise in a purely domestic insolvency. Some of the problems that can arise include the difficulties an insolvency administrator may face in taking possession of assets held in or via a foreign country, uncertainty about the priority of payments where two sets of laws may potentially apply, recognition of the claims of foreign creditors in a local administration, recognition and enforcement of local securities over local assets where a foreign administrator is appointed and the operation of any transaction avoidance provisions. The additional complexities surrounding cross-border insolvencies result in uncertainty, risk and ultimately costs to businesses.

13.2 The Harmer Report recommended that Australia's insolvency laws include provisions which facilitate the recognition of foreign insolvency administrations. They should, among other things, permit Australian courts to give aid to the administrator of a foreign insolvency. The power to act in aid should be capable of being exercised in relation to the voluntary administrations.[1]

13.3 In May 1997, the United Nations Commission on International Trade Law (UNCITRAL) adopted a Model Law on Cross Border Insolvency ('the Model Law'). It recommended that member states adopt it as part of their domestic law. The Model Law provides for judicial cooperation between states in cross-border insolvencies, rights of access for foreign insolvency administrators and recognition of foreign insolvency proceedings by participating states. The major objectives of the Model Law are to provide fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons and to promote cooperation between the courts and other authorities of different countries involved in cases of cross border insolvency.

13.4 CLERP 8 proposed that Australia enact the UNCITRAL Model Law on Cross Border Insolvency as an Australian enactment with only slight modifications to the Model Law as proposed by UNCITRAL.[2]

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1 ALRC Report, vol. 1, para. 975.

2 Media release, CLERP 8: Government Plans to Adopt International Insolvency Law, Sen Ian Campbell, 17 October 2002. A copy of the CLERP 8 Paper: *Proposals for Reform Cross-Border Insolvency* is available from the Treasury website at http://www.treasury.gov.au.

13.5 International efforts to provide solutions to multi-state insolvencies have been difficult to achieve, especially when the insolvency and commercial laws and policies of countries vary so widely. The *European Union Regulation on Insolvency Proceedings*, which came into force on 31 May 2002, is a recent example of such efforts. This Regulation addresses the jurisdictional issues that arise when an insolvency involves a number of different European jurisdictions. It introduces uniform conflicts of law rules, though not substantive rules, for insolvency proceedings and judgements. In broad terms, main insolvency proceedings may be initiated in the member state where the debtor has the 'centre of his main interests'.

13.6 The CLERP 8 Paper notes that Australia is not currently a party to any multilateral conventions on cross-border insolvency. There would appear to be no convention which it could appropriately enter into for this purpose.

13.7 The Committee considers that it would be of benefit to Australian businesses to have internationally recognised and accepted mechanisms in place to deal efficiently with cross-border insolvencies. For Australia, the UNCITRAL Model Law is the leading initiative on this issue. Given Australia's place in the world economy and the past exposure and increasing exposure of Australian businesses to the risks of international trade, it is especially important to adopt policies that promote efficient resolution of cross-border insolvency issues, the reduction of legal uncertainties and the costs of proceedings.

Recommendation 60

13.8 The Committee recommends that Australia adopt the UNCITRAL Model Law on Cross Border Insolvency as proposed in CLERP Paper No 8: Proposals for Reform—Cross-Border Insolvency.

Australia's participation in international insolvency initiatives

13.9 Over the past decade there has been an increasing international focus on the development of global principles and guidelines for insolvency systems. The World Bank, the International Monetary Fund, the OECD, the Asian Development Bank and the European Bank for Reconstruction and Development have all undertaken initiatives aimed at encouraging and assisting emerging market economies to build effective insolvency systems. Other international bodies are also involved in efforts to improve formal and informal insolvency laws and systems including UNCITRAL, the European Union and the Bank of England. The private sector has also contributed. The International Federation of Insolvency Professionals (INSOL) and the International Bar Association's Insolvency and Creditors' Rights Committee (Committee J) have also drawn attention to the need for more transparent and accessible insolvency regimes.

13.10 The impetus for an increased focus on the effectiveness of countries' insolvency systems has its genesis in proposals of the Group of 22 (G22), which met in April 1998 to examine issues relating to the stability of the international financial system against the background of the East Asian financial crisis. The G22 identified

three areas as critical to strengthening the international financial architecture: transparency and accountability; fortifying domestic financial systems; and managing international financial crises. In relation to the last area, a G22 working group highlighted the need to strengthen insolvency and debtor-creditor regimes, develop innovative debt contracts, promote debtor coordination, enhance mechanisms to facilitate orderly debt workouts and encourage better risk management in the private sector.[3]

13.11 In 1999, Australia proposed that UNCITRAL establish a working group to develop a model law on corporate insolvency to foster and encourage the adoption of effective national corporate insolvency regimes. The UNCITRAL Working Group has almost completed the preparation of a Draft Legislative Guide on Insolvency Law. It is expected that the Guide will be finalised and considered for adoption by UNCITRAL in 2004.

13.12 The Committee considers that well functioning insolvency laws are a necessary component of a country's financial architecture and a vital complement to international trade and investment. Australia's participation in international efforts to build credible and effective insolvency systems has the potential to benefit Australian businesses trading overseas and give reassurance to Australians and Australian institutions whose funds are at risk with cross-border operations.

Recommendation 61

13.13 The Committee recommends that the Government play an active role in multilateral forums and international initiatives to strengthen countries' insolvency systems and develop sound practices and principles for insolvency systems taking into consideration differing national legal systems and economic circumstances.

Cross-border insolvency and corporate scoundrels

13.14 Over recent decades, there have been reported cases of hundreds of millions of dollars being lost to creditors in Australia through the sustained and systematic misappropriation of company funds involving complex financial dealings often with the collusion of lawyers, accountants and other professional people. Such schemes frequently involve overseas transactions intended to place the recovery of debts beyond the reach of creditors. Attempting to recover assets from such companies or directors once the company has failed is costly, time consuming and often unproductive.

13.15 The financial scandals involving well known entrepreneurs such as Alan Bond and Christopher Skase highlight the difficulty and expense involved in chasing the

3 For G22 reports on the International Financial Architecture, October, 1998, in particular the Report of the Working Group on International Financial Crises, see http://www.imf.org/external/np/g22/.

money trail to locate assets that have been spirited away.[4] This trail leads investigators through a maze of complicated business arrangements more often than not involving a network of corporate structures in different parts of the world that may act as agents and repositories of assets.

13.16 Mr Max Donnelly et al noted that Mr Robert Trimbole was one of the first of the high profile bankrupts and the first to realise Spain was a bankruptcy haven. While Trimbole's assets in Australia were realised for the benefit of creditors, including a suburban residence which was the subject of competing claims and a rice farm located at Griffith, those held overseas proved out of reach.[5]

13.17 Mr Christopher Skase provides one of the best known examples in Australia of corporate skulduggery where complicated overseas financial transactions involving family and the clever structuring of companies were used to prevent recovery procedures.[6] He faced numerous charges in Australia including 'a set of thirty charges of dishonest conduct, through the provision of false information to independent directors, breach of fiduciary duties owed as a company officer, and improper use of specific provisions under Arts 129, 229(1)(b) and 229(4) of the *Companies (Queensland) Code 1982'*.[7]

13.18 Using Alan Bond as an example, Professor Ken Polk wrote that in cases of complex fraud:

> The criminal investigation can take many months if not years, and involve enormous sums of money. Literally hundreds of thousands of financial transactions will have to be reviewed in the investigations of such crimes, and the money trail may lead literally around the globe. After many years of trying, for example, the Australian policing agencies found that the enormous costs of attempting to trace the money hidden by Bond through accounts in tax-haven countries whose secrecy laws protect all investors (including criminals) was simply not worth the huge expense…
>
> These problems continue into the trial phase as well, since it is not uncommon for complex fraud prosecutions to last for many months.[8]

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4 Public commentary on such cases is extensive but see for example, Paul Barry, 'Swiss Bond', *Sydney Morning Herald,* 11 March 2000; 'A Matter of trust', the *Age,* 14 August 2000;'Why Bond has the last laugh', *Sydney Morning Herald,* 14 August 2000; Crispin Hull, 'Real Victims, real crime, unreal law', the *Canberra Times,* 11 March 2000.

5 Max Donnelly, John Melluish and Ferrier Hodgson, 'High Profile Bankrupts', *Australian Company Secretary,* April 1996, p. 103.

6 Max Donnelly, John Melluish and Ferrier Hodgson, 'High Profile Bankrupts', *Australian Company Secretary,* April 1996, p. 103.

7 Case Note, 'Commonwealth v Skase: a matter of Life or Death or a Nomination for an Oscar', *UNSW Law Journal,* vol. 18 no. 2, 1995, p. 505.

8 Ken Polk, Department of Criminology, University of Melbourne, 'White Collar Crime'.

Recovering assets held overseas

13.19 A number of problems confront a liquidator trying to recover debts from assets held overseas. Because cross-border insolvencies involve a foreign element, such as the assets of the debtor or the creditors being located in more than one jurisdiction, another layer of complexity is added to an already difficult legal situation.[9] Professor Rosalind Mason referred to the circumstances surrounding the failure of a company where 'misgivings and mistrust intrude and goodwill evaporates' which are further heightened by complications due to cross-border transactions:

> In a globalised commercial world, these insecurities sometimes produce behaviour which seeks to take advantage of a world comprising sovereign political entities with disparate, disconnected laws. In particular, corporate debtors through their officers and management may begin to transfer tangible and intangible assets beyond the reach of creditors or remove themselves from the jurisdiction—for reasons of economic self-preservation or deluded notions of saving an inherently profitable enterprise. Well-informed and wealthy creditors may likewise seek to win the race of the diligent to seize debtors' assets abroad. Technological change and the increased mobility of persons and assets (particularly assets transferable electronically) have compounded the problems the law must deal with to restore the conflicting interests of debtors, creditors and the public good which are evident in any insolvency, but especially so in a cross-border administration.[10]

13.20 Indeed, a number of commentators observe that the continuing global expansion of trade and investment is leading to an increase in cross-border insolvencies.[11] In June 2002, the Parliamentary Secretary to the Treasurer, Senator the Hon Ian Campbell acknowledged that 'global economic integration and technological change have created both opportunities and new risks for Australian businesses'. He stated that 'the adoption of efficient cross-border insolvency laws is an important aspect of our efforts to build a sounder international framework to address those risks'. The CLERP 8 Paper on Cross Border Insolvency signalled the Government's intention to give serious consideration to the enactment by Australia of the UNCITRAL Model Law.

13.21 Apart from unravelling the web of financial transactions and establishing the legitimacy of creditors' claims to assets held overseas, the recovery of those assets poses another often formidable problem. The CLERP 8 paper identified the following additional complexities that may arise in a cross-border insolvency context:

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9 Rosalind Mason. 'Cross-border insolvency: Adoption of CLERP 8 as an evolution of Australian insolvency law', *Insolvency Law Journal,* 2003, p. 62.

10 Rosalind Mason. 'Cross-border insolvency: Adoption of CLERP 8 as an evolution of Australian insolvency law', *Insolvency Law Journal,* 2003, p. 62.

11 See for example, David Hanger, 'Cross Border Insolvency: Moving towards the universal treatment of property', *Commercial Law Journal,* June–August 2002, p. 11.

- the extent to which an insolvency administrator may obtain access to assets held in a foreign country;
- the priority of payments:
- whether local creditors may have access to local assets before funds go to the foreign administrator, or whether they are to stand in line with all foreign creditors; and recognition of the claims of local creditors in a foreign administration;
- recognition and enforcement of local securities over local assets, where a foreign administrator is appointed; and
- application of transaction avoidance provisions.[12]

13.22 Mr David Hanger observed that:

> If Australian liquidators have access to property outside the jurisdiction, the effectiveness of the claim to that property will be dependent on the foreign courts acceptance of such claims.[13]

13.23 While Section 581(4) of the Corporations Law allows Australian courts to seek assistance from foreign courts of prescribed countries in relation to 'external administration matters, such assistance may not necessarily be helpful or even forthcoming'.[14] Rachel Morrison noted that:

> The importance of inter-jurisdictional cooperation in these circumstances cannot be overstated. It is difficult enough for liquidators of international companies to collect assets and pay debts. It is even harder when those liquidators are faced with different insolvency laws and courts that might be reluctant to co-operate. The courts in all jurisdictions are at least endeavouring to apply a universality approach to the applications of their insolvency laws.[15]

13.24 The adoption of the UNCITRAL Model Law and Australia's active role in promoting cross-border cooperation in insolvency proceedings will go some way to assist in the recovery of assets located in foreign countries. It does not, however,

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12 Corporate Law Economic Reform Program Proposals for Reform: Paper No. 8, *Cross-Border Insolvency,* Promoting international cooperation and coordination, Commonwealth of Australia, 2002, p. 8. This does not provide the complete list of complexities identified.

13 David Hanger, 'Cross Border Insolvency: Moving towards the universal treatment of property', *Commercial Law Journal,* June–August 2002.

14 Section 581 (4) reads, "The Court may request a court of an external Territory, or of a country other than Australia, that has jurisdiction in external administration matters to act in aid of, and be auxiliary to, it in an external administration matter.'

15 Rachel Morrison, 'Avoiding Inherent Uncertainties in Cross-Border Insolvency: Is the UNCITRAL Model Law the Answer", *IQUILJ,* vol 15, 1999p. 111.

tackle the problem of companies that deliberately set out to conceal assets and place them beyond the reach of legitimate claimants by using overseas companies or foreign transactions to deny access to creditors. Such a recovery process is time consuming and costly. The Committee believes that more should be done to assist creditors in the retrieval of assets held off shore by companies that have collapsed. Using Mr Bond as an example, Mr Paul Barry wrote:

> The key problem for those chasing Bond was that the millions were either hidden in Switzerland or controlled by a man who lived there. And this posed insuperable difficulties for the police and Bond's bankruptcy trustee.

13.25 He stated further:

> With electronic transfers, you can move money twice round the world in 24 hours, yet it takes investigators months, if not years, to get the foreign court orders they need to find the funds. And as soon as investigators get close, the money can be moved again. Meanwhile, those who have hidden the assets can use the courts to stall their pursuers for years. Once money goes offshore, it is difficult and expensive to trace. And lack of funds in bankruptcy or liquidation means there often aren't enough resources to chase the money far enough. More to the point, it is not worth creditors funding the search unless they are likely to get back more than they spend.[16]

13.26 The Committee has noted the problems associated with assetless companies and the lack of funds to pay a liquidator to pursue the recovery of debts. It noted in paragraph 7.42 that 'these circumstances potentially leave an avenue for abuse. More sophisticated phoenix type schemes are conceivable. A company can be set up in Australia to incur debts on a large scale with the proceeds of creditors' funds being sent overseas. The cost and complexity of overseas inquiries poses even greater obstacles to liquidators'.

13.27 In examining the activities of phoenix companies, the Committee found that there are directors who deliberately set out to structure their operations to avoid detection and exploit loopholes in insolvency laws. It found that the main legislative approach dealing with phoenix company activity is to provide for the disqualification of directors in certain circumstances and set penalties for contravening the disqualification.

13.28 In the case of cross-border insolvency, this remedy does not help creditors recover their proper entitlements. Particularly as personal bankruptcy, which brings with it automatic disqualification from being a director for an undeclared bankrupt, can be used as a refuge from meeting obligations.

13.29 At the moment Australia's insolvency laws provide no adequate redress for creditors who are victims of fraud involving cross-border transactions. The Committee

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16 Paul Barry, 'Why Bond has the last laugh', *Sydney Morning Herald*, 14 August 2000.

has already established that the reporting practices of some companies falls far short of requirements and strengthening enforcement in this area may go some way to the early detection of a failing company and of questionable financial transactions. Even so, the Committee believes that rigorous enforcement in this area is only part of the answer.

13.30 The Committee has also recommended that the Government consider creating a statutory process analogous to a Mareva injunction to enable the courts to freeze assets of a director or manager which are prima facie assets on which the corporation has a just claim.[17] Again, the Committee believes that such measures will only partially address the problem of directors of companies deliberately moving assets off shore to escape meeting obligations to creditors of their company.

13.31 The Government should not be content with the current level of protection offered by Australia's insolvency laws to creditors who find themselves the hapless victims of the clever but improper manoeuvrings of company executives and others associated with the misappropriation of company assets. Rather than expend funds on seeking to retrieve overseas assets, a more effective and less costly approach may be to focus on obtaining compensation from the perpetrators of such deception. Because these perpetrators are sophisticated business people adept at concealing their assets and with the best possible legal advice, consideration must be given to taking action against all involved in the misappropriation of funds—family members or associates holding ill-gotten gains and professional advisers facilitating illegal transactions. For example, the Government may consider requiring those responsible for the misappropriation of funds to make good the losses creditors have suffered due to the fraud and for those unable to meet this obligation to be subject to a term of imprisonment. This approach may well place the onus on the debtor to account for missing funds and require relevant third parties to demonstrate that any property at issue was lawfully acquired.

13.32 The Committee is not in a position to recommend specific measures but is convinced that more should and could be done to address this particular problem with cross-border insolvency.

Recommendation 62

13.33 The Committee recommends that the Government examine the problem of cross border insolvency involving the misappropriation of company funds with a view firstly to preventing such activities (improved reporting on the financial affairs of a company, more effective monitoring and enforcement of requirements to keep records and the more effective use of restraining orders in respect of company assets) and secondly to holding those responsible for missing funds or assets accountable for the losses.

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17 See recommendation 33.

Recommendation 63

13.34 The Committee recognises that cross-border insolvency and the bankruptcy of those associated with the financial transactions of a failed company are often interlinked. The Committee recommends that any measures taken in either the Corporations Act or the Bankruptcy Act to effect the recovery of debts or to punish the perpetrators of fraud involved in cross-border insolvency take account of how the laws may interact.

SENATOR GRANT CHAPMAN
CHAIRMAN

LABOR MEMBERS' MINORITY REPORT

In reviewing our corporate insolvency regime, a number of policy objectives must be considered. Some of these objectives diverge. For example, the limited liability of the corporate form can result in the non-payment of legally owed employee entitlements. Governments and the parliament must strive to achieve the appropriate balance in our insolvency laws between potentially competing objectives.

In considering this complex area of law, Labor members have been mindful of a number of key principles. These include:

- The economic benefits of the limited liability company, and its integral place in facilitating investment and economic activity
- The need to ensure that insolvency laws provide for the efficient and orderly disposal of assets
- The need for public confidence in our insolvency regime - the administration of Australia’s insolvency regime must be, and be perceived as being, fair and consistent
- That the interests of various classes of creditors be fairly treated
- The significant adverse consequences for employees whose entitlements are not paid upon insolvency
- Deterrence of abuse of the corporate form
- Encouragement of early intervention into companies in financial difficulty to maximising the prospect of rehabilitation, or at least to seek to minimise the losses flowing from insolvency
- Encouragement of the responsible management of companies.

We recognise that no government can regulate to prevent corporate insolvency. Governments can, however, seek to lessen the possibility of insolvency by encouraging good corporate practice. They can also act to ameliorate the economic and social consequences of insolvency where appropriate. In previous reports of this Committee, Labor members have recommended measures that seek to improve Australia’s system of corporate governance. We have sought to further encourage those principles in this report.

Labor members support many of the recommendations of the Committee, however, there are certain areas where we consider additional or different recommendations are required. These are set out below.

The Independence of Administrators and Liquidators

Labor members agree with the comments made in the Majority's report as to the importance of the independence of administrators and liquidators. The independence of administrators and liquidators is fundamental to public confidence in, and proper functioning of, Australia's insolvency regime.

A substantial amount of evidence was presented to the Committee outlining concerns with the independence of administrators and liquidators, both in relation to specific insolvencies, and more generally. Concerns were primarily focused on

administrators appointed through the Voluntary Administration procedures. For example, the Australian Tax Office, in its submission, suggested that public confidence in the Voluntary Administration is being undermined by a perceived absence of impartiality on the part of some Voluntary Administrators.[1] As the Majority notes in paragraph 3.16 of its report, complaints about the lack of independence of external administrators were commonly expressed in submissions.

Existing legislative provisions directed at the issue of independence of administrators and liquidators set out specific grounds for disqualification (s. 448C, s. 532 and s. 595). However, these provisions do not extend to a number of circumstances that may well require disqualification. For example, the Insolvency Practitioners Association of Australia raised the issue of insolvency practitioners offering inducements to other providers of professional services for the referral to them of insolvency appointments. They recommended that section 595 be extended to cover these circumstances[2]. Labor members support the inclusion of these circumstances within the disqualifying provisions of section 595 as recommended by the Committee.

However, Labor members are of the view that these provisions are insufficient of themselves to ensure the requisite level of independence, whether perceived or actual.

It is the case that the courts have articulated more comprehensive statements as to the obligations on administrators and liquidators, to be, and be seen to be, independent of the directors, shareholders and creditors. Reference was made in the hearings to a number of cases in which the courts have more fully expounded on the obligations of liquidators and administrators[3]. However, in the absence of a clear regulatory framework predicated on such obligations, enforcement of these requirements will generally require recourse to the courts. A number of witnesses before the Committee gave evidence of the practical and financial impediments to creditors applying to the courts on the basis of an asserted breach of these obligations.[4]

The role played by administrators and liquidators is central to the efficient and proper functioning of Australia's insolvency regime. In light of this fact, and given the many concerns raised by submittors on this issue, Labor members are of the view that improvements to the existing regulatory framework are required.

Recommendation 1

Labor members recommend that ASIC, in consultation with the Insolvency Practitioners Association of Australia, develop a code of conduct to ensure that administrators and liquidators, are independent, and are seen to be independent of the company, its members, officers and creditors when they consent to act and act in that capacity.

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1 *Submission* 14, p. 3.

2 *Submission* 22B, p. 1.

3 Commonwealth Bank of Australia v Irving (1996) ACSR 459.

4 For example Brian Gillard, CLA, *Committee Hansard*, 11 November 2003, p. 316.

Labor members further recommend that the provisions of the code be given statutory force by incorporation into the Corporations Regulations or other appropriate means.

The cost of external administrators

A substantial number of witnesses and submittors raised concerns as to the fees charged by insolvency practitioners. This is an issue of particular importance for small business. In addition, concerns were raised regarding the adequacy, and timeliness of disclosure of practitioners' fees and charges.

Labor members are of the view that there are strong grounds for a more transparent system of remuneration for practitioners. Labor members are concerned that the Committee's recommendation 23 permitting ASIC to apply for a review of a practitioners fees is insufficient. Such applications are likely to only be taken in the most extreme of circumstances, and are subject to ASIC's resource limitations and internal priorities. Similarly, the Committee's recommendation 24 is underwhelming, requiring only "encouragement" of best practice standards on remuneration. Labor members consider a more active approach to the issue of fees and charges in this industry are required. We consider the proposal to develop a scale of fees to have merit, although we note certain qualifications ought to apply to the use of such a scale.

Labor members are aware that the Insolvency Practitioners Association previously issued a guide to hourly rates, which was subsequently considered by the then Trade Practices Commission to be a restriction on competition in its report into the professions.[5] Any guidance issued to practitioners on fees and charges would need to be cognisant of the limitations which flow from that report. In addition we are of the view that the guide should contemplate a number of bases for calculating remuneration, not only an hourly rate.

Recommendation 2

Labor members recommend that ASIC, in consultation with relevant industry bodies, develop a guide to fees and charges for insolvency practitioners. Practitioners should not be prevented from charging above these fees, or from calculating their fees on a different basis, provided creditors approving the remuneration are advised by the practitioner of the reasons for departure from the guide.

Disqualification of Directors

There exists, in the current law, a range of provisions directed at preventing, or penalising, abuse of the corporate form. These include the provisions concerning directors' duties, insolvent trading, and the disqualification of directors. These provisions seek to ensure that the benefits associated with the use of the corporation, in particular, its limited liability, are not misused. The most flagrant abuse of the limited liability company is the phoenix company. However, there are other circumstances where misuse, if not abuse, of the benefits of the corporate form

5 See Committee Report paragraph 7.11.

occur. When this occurs, there can be serious adverse consequences particularly for creditors, and employees.

Labor members are concerned that the current regulatory framework does not act as a sufficient deterrent to the establishment of phoenix companies. Evidence was given of their widespread occurrence. [6] Similar concerns were also raised in the Cole Commission report. Labor members also note the evidence of the ATO that there were directors continuing to operate companies, despite having a history of insolvency, who ought to be but were not disqualified.[7]

The Majority report acknowledges some of the deficiencies in the current provisions as to disqualification, and in relation to phoenix company activities. Its recommendations which seek to enhance ASIC's capacity to take action under sections 206D and 206F are a step in the right direction. However, its recommendations fail to properly deal with a central complaint of the disqualification provisions – that they are insufficiently enforced. This is despite acknowledgement that the disqualification provisions are "seldom used."[8] In particular, ASIC's evidence to the Committee in its statutory oversight role, disclosed that no persons were banned under s.206F in the year to June 2003, and as at November 2003 only three disqualifications have been taken. [9]

Labor members are of the view that more effective prevention of phoenix company activity is required. Reliance on provisions which themselves rely on actions by the regulator appears to be an inadequate mechanism to deal with persons who are serial abusers of our system of corporate law to the disadvantage of creditors. Equally, the "automatic" disqualification provisions in s. 206B, as currently drafted, are in our view insufficient to effectively discourage phoenix company activity.

A number of submissions encouraged widening the grounds for automatic disqualification. [10]

The Cole Royal Commission recommended that ASIC's power of disqualification be extended to permit disqualification where a person on one occasion was an officer of a corporation has been wound up and been the subject of a liquidators report. Some criticism of this recommendation was made to the Committee by employer and industry representatives. However, we note that section 206G provides for such disqualification to be disputed, and further that ASIC has the power to grant a disqualified person permission to manage a corporation. These provisions militate against unduly harsh exercise of ASIC's power.

Recommendation 3

Labor members recommend that the Government implement the Cole Royal Commission recommendation that section 206F be amended to allow ASIC to

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6 Mr. Kerr, *Submission* 6, p.12; ACTU, *Submission* 32, p. 13.

7 *Submission* 14, p. 4.

8 Committee report paragraph 8.50.

9 Mr. Drysdale, *Committee Hansard*, 25 November 2003.

10 ATO, *Submission* 14, p. 4; Jones Condon, *Submission* 12, p. 8; QBE Insurance, *Submission* 49.

disqualify a person who on one occasion was an officer of a corporation which has been wound up and been the subject of a liquidator's report.

However, we recognise that in the context of assetless companies, the requirement that there be a liquidators report may lead to difficulties. Where a company owns no assets, creditors may determine not to have a liquidator appointed. Accordingly, we support the Majority's recommendation 28 on this point. Our recommendation is additional to, not in substitution of, that recommendation.

We are also concerned at the apparent lack of compliance activity by ASIC in this area, described above. We recognise that this may be a result of inadequate resourcing, or alternatively the current overly-restrictive grounds under section 206F. If ASIC's compliance work in this area does not increase subsequent to the amendment of section 206F, we recommend consideration of expansion of the grounds for automatic disqualification under section 206B so as to more effectively prevent phoenix company activity.

Recommendation 4

Labor members recommend that the Committee and the government monitor ASIC's activities under the director disqualification provisions of the Act. If it continues to be apparent that insufficient activity is being undertaken under these provisions we recommend that the Government amend the automatic disqualification provisions of the Act to more effectively discouraging phoenix company activity and repeated deliberate corporate insolvencies.

<u>Directors Duties</u>

A number of submissions to the Committee advocated the inclusion in the legislation provision imposing or clarifying obligations on directors. These included the need for a positive duty on directors to take appropriate action when a company is insolvent or likely to become insolvent. Mr. Zwier, in his evidence, pointed out the limitations of the current obligation to not incur debts while insolvent.[11] Whilst the company may not incur further debt, it can continue to trade on a "cash on delivery" basis, which maybe detrimental to the interests of creditors particularly if that continued trading is at a loss or there are antecedent transactions that by effluxion of time fall outside relevant statutory time periods.

Labor members are of the view that there is merit in imposing a clear obligation on directors to act if in their view the company is, or is likely to become, insolvent. Such an obligation is an additional duty directors would owe to the company and clarifies an area in which there is some uncertainty.[12] In addition, it would encourage directors to move to an insolvency administration at an earlier date, thereby increasing the company's prospects of being successfully rehabilitated and maximising potential recoveries. Whilst the Committee's recommendation 14 goes some way towards bringing forward the possibility of voluntary administration, Labor members consider that there ought be a positive duty imposed on directors to act, rather than simply permitting them to do so.

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11 Mr. Leon Zwier, *Committee Hansard*, 7 August 03, p. 128.

12 Ibid.

Recommendation 5

Labor members recommend that the Act be amended to impose an obligation on directors of a company to take appropriate action, particularly the appointment of an administrator, if the company is or is likely to become insolvent.

If such an obligation is imposed, the issue of consequences for failure to discharge the duty arises. It is arguable that creditors whose claims are detrimentally affected by virtue of a failure of a director to discharge the obligation ought to have a claim against the directors personally. However, we consider this issue requires further examination, including its interaction with the existing provisions in the act setting out director's duties and the consequences of non-discharge of them.

Recommendation 6

Labor members further recommend that the Government consider further, and consult on, appropriate remedies arising from a failure to discharge this obligation, including whether adversely affected creditors ought to have a right of action in such circumstances in addition to the company itself.

<u>**Uncommercial transactions and voidable transactions**</u>

The Labor members support the recommendation of the Committee to extend the ambit of the definition of uncommercial transactions, by not requiring that insolvency be a pre-requisite for such transactions.

We are also concerned that the requirement to prove insolvency, other than in those circumstances where a statutory presumption applies, creates similar difficulties for insolvency practitioners in the area of voidable transactions. Cogent evidence on the difficulties presented for liquidators by this requirement was presented by a number of witnesses.[13] Labor members are of the view that the effectiveness of the voidable transaction provisions is necessary to preserve the integrity of our insolvency laws. We also note the recommendation of the Harmer Report to include a statutory presumption of insolvency (90 days prior to commencement of winding up).

Recommendation 7

The Labor members recommend that the Act be amended to provide a statutory presumption of insolvency for the purposes of the application of the voidable transaction provisions. A possible formulation of this presumption is the definition proposed in the Harmer report that a company being wound up is presumed to be insolvent 90 days prior to the commencement of winding up.

We do not consider that this recommendation requires a reconsideration of the Committee's Recommendation 13. The nature of uncommercial transactions renders

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13 Prof Keay, *Committee Hansard*, 14 August 03, p. 214; Mr. Kerr, *Submission* 6, p. 10; Mr. Lucas, *Submission* 33, p. 6.

reliance on a finding as to insolvency inappropriate, even in circumstances where there is a limited presumption in the terms we recommend.

Employee Entitlements

The treatment of employee entitlements upon corporate insolvency involves the balancing of a number of reasonable public policy considerations, and differing interests. Employees, who have had an expectation of their entitlements being paid, can suffer substantial hardship as a result of an insolvency in which these entitlements are not met in full. For these employees, arguments as to the economic benefits of the limited liability character of the corporation are unpersuasive. This is exacerbated in circumstances where there has been a flagrant abuse of the corporate form by unscrupulous persons seeking to avoid due payment of entitlements.

Historically, governments, in the context of insolvency regimes, have sought to recognise the special nature of the employment relationship, and the negative personal and social consequences of non-payment of entitlements. Measures to maximise the likelihood of payment of these entitlements are not new. It has been recognised over many years that the consequences of the principles of limited liability for employees of insolvent companies require some level of amelioration.

Labor members note that the government members' recommendation that employee entitlements not be given a super priority is in direct contradiction of an election commitment given by the Government, and repeated by the relevant government minister. [14]

Government senators have abandoned this election commitment, without providing an alternative policy framework to adequately protect employees' entitlements. The Majority's recommendations in lieu of this commitment fail to sufficiently address the problem of non-payment of entitlements, nor the abuse of corporate insolvency laws by unscrupulous employers.

Labor's proposal for a more comprehensive system for protecting employee entitlements – one which guarantees 100% of legally owed entitlements – obviates the need for maximum priority for entitlements.

The protection of employee entitlements – a better system

The inadequacy of the current GEERS scheme was the subject matter of a number of submissions. Areas of concern included the cap on redundancy entitlements to eight weeks, even in circumstances where an applicable industrial instrument contains a greater entitlement, and the non-inclusion of superannuation contributions. In relation to the former, we note that evidence was presented that suggested in some industries employees have agreed to forgo pay increases or accept lesser increases in return for greater redundancy entitlements.[15] In such

14 Coalition Policy, announced 12 October 2001 included a commitment to "give unpaid employee entitlements…priority over secured creditors…when a business becomes insolvent"; Minister Tony Abbott, restated the commitment when commenting on the collapse of Coogi Textiles, The Age, 18 July 2003.

15 Mr. Watts, ACTU, *Committee Hansard*, p. 98.

circumstances it hardly seems equitable that employees' redundancy entitlements are reduced to the minimum standard.

We note government members of the committee have supported consideration of superannuation contributions in the GEERS scheme.

Criticism was also made of the legal and administrative arrangements for GEERS. The delay in payments, and the effect of Deeds of Company Arrangements on access to the entitlement were raised. The Committee took evidence from two former employees of an insolvent company, who gave evidence that they had been unable to obtain payment under the GEERS due to the terms of the applicable Deed of Company Arrangement.[16] Given the circumstances in which that Deed was entered into, (the meeting of creditors took place in a different state to the one in which many employees resided) and the lack of understanding of these employees as to the effect on their GEERS applications of the terms of the Deed; their non-entitlement on these grounds appears harsh. We support the Committee's recommendation 49 as to "discriminatory deeds", which seeks to address this problem at the point of the inception of the Deed.

Labor members are of the view that a more comprehensive scheme for the protection of employee entitlements is required. In our view, such a scheme ought to cover the entirety of an employee's legal entitlements, including applicable redundancy and superannuation contributions. Labor has previously stated than an enhanced scheme should be funded by a 0.1% levy on businesses with more than 20 employees, collected along with compulsory superannuation contributions. In the recommendation below we set out the key objectives of Labor’s proposal.

Recommendation 8

Labor members recommend an alternative model for the protection of employee entitlements in circumstances of corporate insolvencies, with the objective of replacing GEERS with a scheme that:

- **Protects 100% of the employee's legal entitlements**
- **Protects applicable superannuation contributions**
- **Ensures timely access to payments**
- **Ensures that payments are not obstructed by the terms of any Deed of Arrangement and**
- **Does not impose additional costs on small business**

Reporting of employee entitlements

A number of submissions proposed that employers be required to give information to employees about the provision made for employee entitlements.[17] Indeed, as the Committee report notes, many submissions from the business sector had little

16 Ms Elizabeth Fullerton, *Submission* 31; Mr. Nicholas Bishop, *Submission* 36, and additional information – letters dated 9 October 2002, 7 May and 11 August 2003 from DEWR regarding Open Telecommunications Ltd, the Deed of Company Arrangement and its effect on employees’ entitlements under GEERS.

17 ACTU, *Submission* 32, p.12.

difficulty with a requirement to report on accrued liabilities, which are reported in the company's audited financial statements.[18]

However, evidence from the some aspects of the business sector opposed any requirement to report on provision being made for contingent entitlements such as redundancy payments. The basis for this opposition appears to be the uncertain nature of contingent liabilities, the changeable quantum of such liabilities given changes to the workforce (including length of service), and some dispute as to how such liabilities should be recognised for accounting purposes.[19] In addition, concerns were raised as to any requirement that might involve a company providing commercially sensitive information.

The Labor members do not consider it unreasonable for employers to provide an indication to their employees that provision is being made for these lawfully owed entitlements. In practice, these are matters to which directors must necessarily turn their minds, particularly if the company is experiencing financial difficulty. Employees are entitled to reasonable information as to payments about which they have a legitimate expectation.

However, we recognise that the provision of commercially sensitive information is problematic. Given that accrued entitlements are generally reported in the company's financial accounts, we consider it is appropriate for a statement to be made in that context that appropriate provision has been made for both accrued and contingent liabilities. We consider that this proposal has the advantage of streamlining this statement into the existing reporting requirements under the Act so as to avoid unnecessary duplication.

We also accept that some distinction must be drawn as between accrued and contingent liabilities, given that the latter are more difficult to quantify. However, both accrued and contingent liabilities are matters which directors must consider. Our recommendation seeks to encourage consideration, and reporting, by directors of provision being made for employee entitlements.

Recommendation 9

The Labor members recommend that the Corporations Act be amended to require companies to include a statement in the annual report that sufficient provision has been made for accrued entitlements and that appropriate measures are in place to cover contingent liabilities.

The Labor members recommend that appropriate remedies are considered in order to provide an adequate deterrent in the law against misleading statements.

Recovery of employee entitlements

Labor members share the concerns expressed in the Majority report that Part 5.8A of the Corporations Law presents substantial difficulties in application, in its current

18 See paragraph 10.90 Committee Report.

19 See paragraphs 10.94 – 10.100 Committee Report.

terms. In particular, to make out a breach of section 596AB, an intention to avoid recovery of entitlement must be proved. This presents substantial practical and evidentiary challenges. In our view, section 596AB is a reasonable statement of deterrence, but other mechanisms ought to exist which enable assets of related companies to be brought into the liquidation process where appropriate.

Labor members believe that the recommendation of the Harmer report as to the power of the court to make contribution orders should be revisited. Labor senators have previously moved amendments to the Corporations Law (Employee Entitlements) Bill 2000 seeking to enable recovery from related body corporates by liquidators, creditors or ASIC in appropriate circumstances. [20] These were not supported by the government.

We understand that concern may be raised with the extension of liability to related bodies. We emphasise that these concerns can be reasonably addressed by the legislature setting out specified grounds for, and circumstances in which, an order could be made. Labor members believe that the legislation needs to be recast in order to ensure that the stated objectives of the Corporations Law Amendment (Employee Entitlements) Act are achieved.

Recommendation 10

Labor members recommend that the Corporations Act be amended to enable a liquidator, creditor or ASIC to apply to the Court for an order that a related body corporate in appropriate circumstances pay the whole or part of the amount of a debt of an insolvent company. We recommend that the grounds on which a Court can make such an order be the subject of further consultation. We further recommend that intention to avoid liability ought not to be a prerequisite to the making of such an order.

SENATOR PENNY WONG
DEPUTY CHAIR

MR ANTHONY BYRNE MP

SENATOR STEPHEN CONROY

MR ALAN GRIFFIN MP

20 Amendments moved by Senator Conroy to Corporations Law Amendment (Employee Entitlements) Bill 2000, on 10 May 2000.

APPENDIX 1

SUBMISSIONS AND TABLED DOCUMENTS

1	Confidential
2	Mr Peter Boardman
3	Confidential
3A	Confidential
3B	Confidential
4	Mr Bradley Peppinck
5	Mr Tony McLean
5A	Mr Tony McLean (Supplementary)
6	Mr David Kerr
6A	Mr David Kerr (Supplementary)
7	Confidential
7A	Confidential
8	Confidential
9	Confidential
10	Confidential
11	The Association of Superannuation Funds of Australia Limited
11A	The Association of Superannuation Funds of Australia Limited (Supplementary)
12	Jones Condon Chartered Accountants et al
12A	Jones Condon Chartered Accountants (Supplementary)
13	Australian Chamber of Commerce and Industry
14	Australian Taxation Office
15	D'Aloia Handberg
15A	D'Aloia Handberg (Supplementary)
15B	D'Aloia Handberg (Supplementary)
16	Council of Small Business Organisations of Australia Ltd
17	Pacific Capital Corporation Ltd
18	Business Turnaround Association
18A	Business Turnaround Association (Supplementary)
19	Deloitte Touche Tohmatsu
20	Logie-Smith Lanyon, Lawyers
21	Ernst & Young

22	Insolvency Practitioners Association of Australia
22A	Insolvency Practitioners Association of Australia (Supplementary)
22B	Insolvency Practitioners Association of Australia (Supplementary)
23	CPA Australia
23A	CPA Australia (Supplementary)
23B	CPA Australia (Supplementary)
24	Australian Securities & Investments Commission
24A	Confidential
25	Department of the Treasury
26	Law Council of Australia
26A	Law Council of Australia (Supplementary)
26B	Law Council of Australia (Supplementary)
27	Australian Institute of Company Directors
28	Australian Bankers' Association
28A	Australian Bankers' Association (Supplementary)
29	Confidential
30	National Farmers' Federation
31	Ms Elizabeth Fullerton
32	ACTU
33	Mr Peter Lucas CA
34	Mr Colin Anderson et al
35	Confidential
36	Mr Nicholas Bishop
36A	Mr Nicholas Bishop (Supplementary)
37	The Institute of Chartered Accountants in Australia et al
38	Australian Industry Group
39	The Australian Workers' Union
40	Confidential
40A	Mr Rodney Bennett (Supplementary)
41	The Commercial Law Association of Australia Limited
42	Mr Rodney Bennett
43	Minter Ellison Lawyers
44	Australian Finance Conference
44A	Australian Finance Conference (Supplementary)
45	Australian Manufacturing Workers' Union
46	Confidential

47	Independent Contractors of Australia
48	QBE Insurance (Australia) Limited
49	Heads of Workers' Compensation Authorities, WorkCover, WA
50	Lawler Partners Chartered Accountants
51	Sims Partners
52	Insolvency Notices Pty Ltd
53	Australian Credit Forum
54	NSW Division of the Australian Institute of Credit Management
55	Mr Nicholas Carter
56	CFMEU Construction & General Division
57	Dr Rosalind Mason
58	Mr Hans S Roleff

ADDITIONAL INFORMATION/TABLED PAPERS

Department of the Treasury—answers to questions taken on notice during hearing by Senate Economics Legislation Committee from 3 to 6 June 2003.

Letter dated 29 July 2003 from the Department of the Treasury responding to questions taken on notice at the hearing on 26 June 2003.

Letter dated 7 August 2003 from Mr Kevin Davis, University of Melbourne, enclosing article, 'Protecting Employee Entitlements' co authored by Kevin Davis and Geoff Burrows and published in the Australian Economic Review.

Letter dated 14 August 2003 from Mr Nicholas Bishop enclosing copies of two letters from the Department of Employment and Workplace Relations, dated 9 October 2002 and 7 May 2003, regarding Open Telecommunications Ltd, Deed of Company Arrangement and its effect on employees' entitlements under GEERS.

Letter (undated) received on 28 August 2003 from Mr Nicholas Bishop enclosing copy of letter from the Department of Employment and Workplace Relations, dated 11 August 2003 regarding Open Telecommunications Ltd and GEERS.

Copy of letter dated 17 June 2003 from the Australian Securities and Investments Commission to Ms Elizabeth Fullerton regarding Open Telecommunications Ltd and GEERS. (Copy provided to Committee on 7 August 2003.)

Letter dated 12 August 2003 from the Law Council of Australia, regarding entry requirements for registered and official liquidators.

Copy of letter dated 7 May 2003 from the Department of Employment and Workplace Relations to Ms Elizabeth Fullerton regarding Open Telecommunications and GEERS.

Letter dated 23 September 2003 from the Australian Securities and Investments Commission providing complaints statistics on insolvency practitioners for 2002 2003.

Paper (undated) tabled at the Committee's hearing on 11 November 2003 by Mr Ron Hardaker, Australian Finance Conference. The paper provides case studies to illustrate the impact of proposed changes to priority of employee entitlements.

Letter dated 19 December 2003 from the Australian Institute of Company Directors, responding to questions taken on notice at the Committee's hearing on 11 November 2003.

Email dated 31 December 2003 from the Business Turnaround Association, responding to questions taken on notice at the Committee's hearing on 12 November 2003.

APPENDIX 2

PUBLIC HEARINGS AND WITNESSES

FRIDAY, 23 MAY 2003 - TOOWOOMBA

MASON, Associate Professor Rosalind Foote (Private capacity)

THURSDAY, 26 JUNE 2003 - CANBERRA

AUSTRALIAN TAXATION OFFICE
CHARLES, Mr Robert, Assistant Commissioner, Operations
HOLLAND, Ms Erin, Deputy Commissioner, Operations
TOPPING, Mr Gregory, Assistant Deputy Commissioner, Operations

DEPARTMENT OF EMPLOYMENT AND WORKPLACE RELATIONS
CONNELL, Ms Jenet, Group Manager, Workplace Relations Services
LLOYD, Mr John, Deputy Secretary
MAYNARD, Mr Michael Charles, Assistant Secretary, Employee Entitlements Branch

DEPARTMENT OF THE TREASURY
SELLARS, Mr Andrew Newell, Manager, Governance and Insolvency Unit, Corporations and Financial Services Division

THURSDAY, 7 AUGUST 2003 - MELBOURNE

BISHOP, Mr Nicholas Robert (Private capacity)

ASSOCIATION OF SUPERANNUATION FUNDS OF AUSTRALIA LTD
ABRAMOVICH, Mr Mark Daniel, Member, and Partner, Deacons
PRAGNELL, Dr Bradley John, Principal Policy Adviser

AUSTRALIAN CHAMBER OF COMMERCE AND INDUSTRY
ANDERSON, Mr Peter Christian, Director, Workplace Policy

CRUTCHFIELD, Mr Philip David, Barrister (Victorian Bar)

D'ALOIA HANDBERG
D'ALOIA, Mr Anthony, Partner

FULLERTON, Ms Elizabeth (Private Capacity)

ERNST AND YOUNG
GEORGAKIS, Mr John, Partner, Corporate Finance Restructuring

MINTER ELLISON
MOLLER, Mr Carl
WALKER, Mr Ian, Partner

AUSTRALIAN COUNCIL OF TRADE UNIONS
WATTS, Mr Richard Keith, Senior Industrial Officer

ARNOLD BLOCH LEIBLER
ZWIER, Mr Leon, Member and Insolvency Practitioner

FRIDAY, 8 AUGUST 2003 - MELBOURNE

AUSTRALIAN WORKERS' UNION
GILLAM, Mr Trent, National Corporate Research Officer
HEATH, Mr Colin, Secretary, TAPS Branch

CPA AUSTRALIA
LOPEZ, Mr George Aubrey, Chairman, Centre of Excellence, Insolvency and Reconstruction
MULCARE, Mrs Catherine Mary, Policy Adviser, Corporate Reporting and Governance
PURCELL, Mr John Anthony, Technical Adviser, Management and Business

AUSTRALIAN INDUSTRY GROUP
SMITH, Mr Stephen Thomas, Director, National Industrial Relations

THURSDAY, 14 AUGUST 2003 - CANBERRA

INSOLVENCY AND TRUSTEE SERVICE AUSTRALIA
BERGMAN, Mr David, Adviser, Policy and Legislation
GALLAGHER, Mr Terry, Inspector-General in Bankruptcy

LAW COUNCIL OF AUSTRALIA
CLARKE, Mr Jon, Chair, Insolvency and Reconstruction Committee, Business Law Section
GOODE, Mr Andrew Britten, President, Law Society of South Australia
GOTTERSON, Mr Robert William, QC, President-elect
GREENTREE-WHITE, Mr James Russell, Lawyer, Legal and Policy
MELLICK, Ms Kate, Lawyer, Legal and Policy

KEAY, Prof. Andrew Richard, (Private capacity)

TUESDAY, 19 AUGUST 2003 - CANBERRA

INSOLVENCY PRACTITIONERS ASSOCIATION OF AUSTRALIA
ARNOLD, Mrs Kim Lee-Anne, Technical Director
CARTER, Mr Bruce James, President

WEDNESDAY, 20 AUGUST 2003 - CANBERRA

AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION
COLLIER, Professor Berna, Commission Member
DOPKING, Mr Stefan, Director, National Insolvency Coordination Unit
DRYSDALE, Mr Mark, Executive Director, Public and Commercial Services

NATIONAL FARMERS FEDERATION
HARRIS, Miss Denita, Policy Manager and Industrial Advocate
POTTER, Mr Michael, Economics Policy Manager

COUNCIL OF SMALL BUSINESS ORGANISATIONS OF AUSTRALIA LTD
POTTER, Mr Mike Edmund, Chief Executive Officer

WEDNESDAY, 17 SEPTEMBER 2003 - CANBERRA

HARMER, Mr Ronald Wilson (Private capacity)

TUESDAY, 11 NOVEMBER 2003 - SYDNEY

AUSTRALIAN MANUFACTURING WORKERS UNION NEW SOUTH WALES
BASTIAN, Mr Paul, State Secretary

COMMERCIAL LAW ASSOCIATION OF AUSTRALIA
DREISE, Mr Anthony John, Council Member
FINNANE, Mr Edmund Thomas, Member, Legislative Review Task Force
GILLARD, Mr Brian James, Committee Member
KEOGH, Dr John, President; Chair of Legislative Review Task Force

AUSTRALIAN BANKERS' ASSOCIATION
GILBERT, Mr Ian Bruce, Director
HOSSACK, Mr Nicholas, Director, Prudential, Payments and Competition Policy

AUSTRALIAN FINANCE CONFERENCE
HARDAKER, Mr Ron, Executive Director
TIERNEY, Ms Alison, Corporate Lawyer
CULBERT, Mr Geoffrey, General Counsel, GE Commercial Finance
MILLIN, Mr Jon, Associate Director, GE Commercial Finance

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS
IPP, Mr Stephen, Law Committee Member
UPTON, Ms Gabrielle, Senior Policy Officer

KERR, Mr David John, (Private capacity)

COMMONWEALTH BANK OF AUSTRALIA
LEONARD, Mr Michael, Executive General Manager, Group Risk Management

WEDNESDAY, 12 NOVEMBER 2003 - SYDNEY

NEW SOUTH WALES DIVISION OF THE AUSTRALIAN INSTITUTE OF CREDIT MANAGEMENT
FRANCIS, Mr David, Representative, Australian Credit Forum; and Chairman, Law and Legislation Committee

BUSINESS TURNAROUND ASSOCIATION
HEDGE, Mr Peter, Committee Member
O'NEILL, Mr Michael Phillip, Committee Member
SAUER, Mr Robert George, Director

JONES CONDON, CHARTERED ACCOUNTANTS
JONES, Mr Michael, Partner

AUSTRALIAN CREDIT FORUM
SMITH, Mr Barry James, Deputy Chairman

APPENDIX 3

PREVIOUS REVIEWS: REVIEW OF THE REGULATION OF CORPORATE INSOLVENCY PRACTITIONERS

Report of the Working Party June 1997

A Working Party was established in 1993 to review the regulation of corporate insolvency practitioners. The review arose from recommendations for changes to the system for the regulation of insolvency practitioners made by the Harmer Report and the Trade Practices Commission in its 1992 Study of the Professions. The Working Party's mandate was to consider and make recommendations as to whether any changes should be made to the current system for the registration, appointment and remuneration of insolvency practitioners, as well as to the procedures for responding to complaints about the conduct of corporate insolvency administrations.

The key findings and recommendations made by the Working Party in this Report are:

Corporate and Personal Insolvency Regulatory Systems (Chapter 4)

The Government should examine further the costs and benefits of establishing a merged regulatory framework for personal and corporate insolvency with separate 'tickets' for each area of practice.

Registering Authority (Chapter 5)

The registration function for corporate insolvency practitioners should continue to be carried out by the Australian Securities Commission ('the ASC'). If, in the longer term, a merger of the regulatory systems for personal and corporate insolvency proceeds, the registration function should be carried out by a statutory board.

Registration Requirements (Chapter 6)

Categories of Practitioners

The two categories of official and registered liquidators may need to be retained in the short term. In the longer term, the distinction should be removed in favour of a system whereby the court may sanction any nominated registered liquidator to perform a court ordered administration.

Registration for Specific Administrations

The Government should consider amending the Corporations Law to extend the ASC's discretion to allow persons with specialised expertise relevant to one off administrations to conduct those administrations, notwithstanding that they are not registered liquidators.

Entry Requirements

The entry requirements for registered liquidators should be broadened so that persons with various combinations of qualifications and experience would be eligible to apply for registration. In addition, all applicants should be required to successfully complete a specialised course or examination in insolvency practice, or demonstrate equivalent knowledge, as approved by the registering authority, and satisfy ‘fit and proper person’ requirements.

To be a registered liquidator, membership of a professional organisation should not be a mandatory requirement, but the registering authority should be allowed to streamline applications from members of relevant professional organisations (such as the Insolvency Practitioners Association of Australia, the Australian Society of Certified Practising Accountants, the Institute of Chartered Accountants of Australia and the legal professional bodies) in order to facilitate the registration process.

The registering authority should have powers to waive part some or all of the entry requirements (except the ‘fit and proper person’ requirements) in exceptional cases. In particular, transitional arrangements should allow exemptions from the requirements for a very small number of senior lawyers with significant insolvency experience.

The amount of work generally available to official liquidators should not be a factor in determining whether a person should be granted official liquidator status.

The current requirements concerning supervised experience and resources for applicants seeking official liquidator status should be retained, for the present, pending the abolition of the official liquidator class. However, the practice in New South Wales of admitting regional practitioners to a separate ‘country list’ of official liquidators is anomalous and all future applicants in New South Wales should be required to satisfy the usual requirements for official liquidator status.

General Supervision (Chapter 7)

Ethics and Professional Standards

The law should not mandate adherence to a code of conduct and ethical standards by insolvency practitioners.

Continuing Education

There should be an ongoing requirement for practitioners to undergo continuing professional education as agreed between the professional bodies and the ASC. The professional bodies and the ASC would specify continuing education programs administered by the professional bodies and review these at least every two years.

Ongoing Work Experience

The ASC should be permitted to require a registered liquidator who does not perform any substantive insolvency work over a period of five years [or an official liquidator

who does not perform any substantive insolvency work over a period of two years], to show cause why his or her registration (or official status) should not be cancelled.

Surveillance

The ASC should retain its complaints based surveillance program and examine the feasibility of reviving the surveillance program it previously operated. The ASC and the professional bodies should examine whether there is scope for greater mutual education and cooperation in the surveillance area.

Insurance

The current system whereby the ASC allows practitioners to take out professional indemnity insurance instead of security deposits on condition that practitioners comply with requirements of a professional body is working satisfactorily. It does not require any immediate change except to expand it to encompass the legal professional bodies. In the long term, professional indemnity insurance could be expressly recognised as an ongoing requirement of registration in legislation and facilities used to monitor compliance, for example, by requiring practitioners to submit details of insurance on the annual statement or having a professional body certify maintenance of cover to the ASC.

Ongoing Reporting

The utility of the periodic report required to be prepared by practitioners would be enhanced if it:

- was made into an annual statement, rather than triennial; and
- required practitioners to provide, in addition to personal particulars:
- certification of professional development courses undertaken;
- a summary of insolvency work undertaken; and
- details of professional indemnity insurance.

For ongoing periodic reporting requirements which overlap with requirements imposed by the professional bodies, there could be a streamlined system whereby practitioners could comply merely by providing evidence of continuing membership of a professional body.

Failure to comply with the ongoing requirements in respect of such matters would allow the ASC to issue a notice requiring the practitioner to show cause why he or she should not be deregistered and the ASC should have powers to deregister a practitioner if not satisfied with the response.

Discipline and Remedial Supervision (Chapter 8)

Disciplinary Procedures

The statutory disciplinary procedure involving the ASC, the Companies Auditors and Liquidators Disciplinary Board ('the CALDB') and the appeal mechanism to the Administrative Appeals Tribunal should be retained for conduct matters. However, the professional accounting and legal bodies should also have a right to bring a matter before the CALDB. Administrative matters should be dealt with by the registering authority, which is currently the ASC.

Penalties

The CALDB should be given greater flexibility in the penalties it may impose and should be given powers to enforce orders made during the pre hearing period and to use mediation and arbitration.

Inquiries and Reports

The ASC's powers to carry out inquiries into conduct should remain. However, consideration should be given to whether the ASC should be permitted to exercise compulsive powers for this purpose, or at least be given an express power to request the court to exercise its own compulsive powers for this purpose. The ASC should also retain its existing powers to submit reports to the court and apply for remedial orders.

The ASC's general powers to report misfeasance, neglect or omissions to the Court and to apply to the Court for orders where an administrator is managing company affairs in a manner prejudicial to the interests of creditors, removing the administrator and in cases of fraud, negligence or breach of trust are appropriate and should be retained. These powers provide a significant degree of flexibility to enable the ASC under the scrutiny of the court to ensure that any person adversely affected by the default of an administrator may be compensated.

The provisions of the Corporations Law concerning the role of the court in supervising practitioners should be reviewed.

Appointment (Chapter 9)

In the long term, consideration be given to changing the Corporations Law framework to minimise the distinction between court ordered and voluntary liquidations in terms of the qualifications and appointment of liquidators. The Working Party envisages that these changes would see the abolition of the category of official liquidator altogether.

The rules relating to the selection of liquidators by the court should be made part of the Corporations Law in order to establish uniformity across jurisdictions.

Selection System

The system for appointments of corporate insolvency practitioners by the court should be based on nomination by the petitioning creditor with a 'back up' rotation system if the nomination is not or cannot be made successfully. The court should be given power to reject a nomination on its own motion or on the application of an interested party.

Entry on the backup rotation system should be compulsory for all official liquidators pending abolition of that class and/or establishment of a funding mechanism for assetless administrations.

Remuneration (Chapter 10)

Reporting Obligations

The ASC should work together with the professional bodies to develop guidelines that assist practitioners identify the types of possible misfeasance which practitioners must report to the ASC and provide some indication of the level of detail that the ASC expects in reports.

Fee Setting

The ASC, in consultation with the relevant professional bodies, should consider appropriate means to educate creditors and practitioners about the different methods of fee setting available and the rights which creditors have with regard to establishing fees so as to encourage greater involvement by creditors in fee setting.

The notices to creditors of a meeting to determine fees of insolvency practitioners should set out a proposal for remuneration as well as a summary of the creditors' rights to vary the proposal.

Where time based methods are used to determine fees, the practice of 'capping' fees should be encouraged.

The method of calculating hourly rates in the Guide to Hourly Rates published by the Insolvency Practitioners Association of Australia should be better explained, particularly in connection with overheads and disbursements.

Fee Review

Creditors should be given greater education about existing fee review mechanisms. The formal review mechanisms should be extended to encompass all types of corporate insolvency administrations. Consideration should be given to empowering the CALDB to hear and make appropriate orders in relation to fee disputes in consultation with the professional bodies (particularly the Insolvency Practitioners Association of Australia).

The informal mediation system dealing with fee disputes, currently administered by the professional bodies, should be encouraged to continue.

Assetless Administrations

A levy should be imposed on all companies, either at the time of incorporation or as part of the annual return fee, as a means of funding assetless administrations. The fund should be administered by the ASC and should apply to compulsory liquidations where there are no assets. It should provide liquidators with enough funds to prepare a report to creditors and a report to the ASC.

The ASC should liaise with practitioners to develop guidelines about the content of reports, particularly in cases of assetless companies, which should serve to avoid needless work on the part of the practitioners.

Duties and Responsibilities of Controllers (Chapter 11)

The burden of the administrative requirements on controllers and managing controllers should be reduced while still maintaining an adequate level of protection for third parties by addressing both the scope, and the content, of the obligations.

The ASC should become the source of public information concerning controllerships and the Gazettal requirements should be abolished.

All controllers should be required to notify the ASC and the chargor company that they have been appointed over corporate property and the nature of the property concerned.

All controllers should be required to provide a 'status update' every six months after appointment which details the property still subject to the controllership and any property which has been disposed of or returned.

All controllers should be required to provide a final report to the ASC when an appointment has lapsed due to disposal or return of the assets concerned and, where applicable, provide a report on sale proceeds and dispersal of proceeds.

Managing controllers should be redefined to include only those controllers who have taken control or possession of the whole or substantially the whole of a company's assets or those controllers who actually exercise powers of management (with the question of what is substantial left to the common law).

The company officers should be responsible for preparing and lodging a report as to affairs when a controller is appointed and, if an extension of time is needed, they should be required to apply to the ASC (rather than to the controller).

Controllers other than managing controllers should be required to lodge a notice with the ASC commenting on the report as to affairs provided by the company officers within one month of receiving the report.

Managing controllers should be required to prepare and lodge a separate report as to affairs within two months of appointment and that report should include comments on the report as to affairs prepared by the company officers.

Only managing controllers should be subject to a requirement to open a separate bank account where they have received money which is required to be accounted for.

Managing controllers should be required to report possible misconduct on the part of company officers to the ASC.

The suitability of the forms required to be lodged by controllers should be reviewed.

FINAL REPORT OF THE COMPANIES AND SECURITIES ADVISORY

ON

CORPORATE VOLUNTARY ADMINISTRATION

List of Recommendations

The first and major meetings of creditors

RECOMMENDATION 1

The first meeting of creditors should be retained.

RECOMMENDATION 2

The time for holding the first meeting should be increased to 8 business days after the beginning of the administration, with 5 business days' notice of the meeting to creditors.

RECOMMENDATION 3

There should be a specific provision stating that creditors may only remove an administrator and appoint a replacement administrator through a single resolution.

The prospective replacement administrator should table at the first meeting, prior to any resolution:

- a written consent to act, and
- a statement of interest.

RECOMMENDATION 4

The directors' statement about the company's business, property, affairs and financial circumstances should be tabled:

- at the first meeting of creditors, or
- if the administrator allows directors a longer period to provide this statement - at the major meeting of creditors.

RECOMMENDATION 5

The reports sent by administrators when convening the major meeting of creditors should be required to include "any other matter material to the creditors' decision".

RECOMMENDATION 6

The period for holding the major meeting should be extended to 25 business days, with a new convening period of 20 business days.

The administrator should be permitted to hold the major meeting before the end of the convening period.

RECOMMENDATION 7

The convening period time should be calculated from the day after the administration begins.

RECOMMENDATION 8

The court's power to extend the convening period should be exercisable on an application made after the convening period has ended only where there would otherwise be substantial injustice to creditors. The court should have regard to the administrator's conduct when considering the costs of that application.

RECOMMENDATION 9

The current 60 day maximum time by which creditors can adjourn meetings should be reduced to 30 business days after the first day on which the meeting is held. However, the court should be given a specific power to permit creditors to adjourn meetings to a date after that period, on application by the administrator.

RECOMMENDATION 10

All the directors of a company under administration should be required to attend creditors' meetings, but should not be obliged to answer questions. A director should only be excused from attendance if:

- the director can show reasonable cause for failure to attend, or
- the director's absence has been approved by the administrator or by a resolution of the creditors.

In addition, creditors at each meeting should have the power to direct attending directors to leave the meeting for all or part of the remainder of that meeting.

RECOMMENDATION 11

The administrator and the company should execute a deed that is fully approved at the major meeting within 15 business days of its approval, or such further period as the court allows on application made by the administrator within those 15 business days.

RECOMMENDATION 12

Where a deed is not fully approved at the major meeting, the administrator must draft a deed within 10 business days following the creditors' decision at that meeting. The court should have a power to extend this time on application by the administrator within that 10 business day period. Creditors should thereafter have 3 business days to inspect the draft deed. The administrator and the company should execute the deed within 2 business days following the end of the inspection period. However, the court should have a power to extend that 2 business day period for executing the deed on application by the administrator within that period.

Creditors should be informed at the major meeting:

- of their rights to inspect and comment on the draft deed
- that the final executed deed may not be in accordance with the draft document and that the administrator retains the ultimate responsibility for drafting the deed.

Voting at creditors' meetings

RECOMMENDATION 13

The current dual majority by value and number voting requirement, with the administrator having a casting vote to resolve any deadlock, should be retained.

RECOMMENDATION 14

The current court power to overturn a resolution whose outcome was determined by the votes of related party creditors should remain.

RECOMMENDATION 15

Directors and administrators should have a duty to disclose arrangements of which they are aware and under which persons are required, or may become entitled, to vote a particular way on a proposal. That obligation should remain up to the time of the poll.

RECOMMENDATION 16

Secured creditors should be able to vote for the full amount of their debts in meetings while the company is under administration or under a deed of company arrangement.

RECOMMENDATION 17

Any person should be permitted to vote for or against any resolution in accordance with a special proxy, whether or not that vote is to the person's financial advantage.

RECOMMENDATION 18

Persons should be prohibited from voting general proxies for or against any resolution in which they are financially interested.

RECOMMENDATION 19

Employees should be permitted to vote on a deed of company arrangement as creditors, even if they have priority under that deed.

RECOMMENDATION 20

The court should be able to order that creditors who are also the owners of property that is pooled in a single enterprise forming part of the company's business should be a class of creditors for the purpose of voting on a deed of company arrangement. The deed should bind all those creditors if a majority in number, and three quarters in value, of those present and voting vote to accept the deed.

Effect of appointment of administrator on creditors

RECOMMENDATION 21

There should be no additional restriction on contractual provisions which enable a party dealing with a company to take certain action merely because the company appoints an administrator.

RECOMMENDATION 22

Persons who hold property of a company under administration as security under a lien or pledge should be entitled to retain possession of that property. However, they should not be entitled to exercise any rights under the lien or pledge to sell that property during the course of a voluntary administration.

RECOMMENDATION 23

Administrators should have a right to sell property subject to liens, pledges and reservation of title clauses, provided that the property is sold as part of the ordinary business of the company or as part of a sale of the business as a going concern to a third party. For the purpose of determining "the ordinary business of a company", any demand by a reservation of title creditor to return property should not, of itself, take any subsequent sale outside the ordinary business of the company. Likewise, a sale of property subject to a lien or pledge should not be outside the ordinary business of a company merely because the lienee or pledgee has possession of that property.

Lienees, pledgees or reservation of title creditors should have a right to apply to the court if they consider that they will be prejudiced if the sale of the property were to proceed.

Where that property is also subject to a charge, the administrator may sell the property only if the sale is in the ordinary course of business, with the written consent of the chargee or with the leave of the court.

Potential purchasers should have a statutory right of reasonable access to inspect any property held by lienees or pledgees.

The purchaser should obtain clear title to the property being sold, including the right to possession.

Administrators who exercise these rights of sale should have an immunity from any action in conversion.

In the case of property subject to liens and pledges, the administrator's right should be subject to an obligation to retain the amount secured by the lien or pledge and by any other security over the property having a higher priority in law or equity than the lien or pledge, for payment to the holders of those securities. If the administrator sells the property for a lower amount, the administrator should be personally liable for the shortfall.

In the case of property subject to a reservation of title clause, the administrator's right should be subject to an obligation to retain the invoice price of the property and any amount due to a person with a higher priority over that property, for distribution to the reservation of title creditor and that other person, if any. If the administrator sells the property for a lower amount, the administrator should be personally liable for the shortfall.

Administrators should have a right to apply to the court for an order enabling them to sell property held by lienees or pledgees or subject to a reservation of title clause without incurring personal liability where that immunity from liability would be reasonable in all the circumstances.

RECOMMENDATION 24

Except where another creditor has a higher priority, the administrator may agree to a lienee, pledgee or reservation of title creditor selling the property and retaining an amount to cover the relevant debt (and returning any surplus to the administrator). Where this occurs, the administrator would have no personal liability to the selling creditor, even where the sale price is less than the debt.

Creditors should not be able to exercise rights of sale under distress for rent, or workers' liens, during an administration.

RECOMMENDATION 25

There should be an exemption from the moratorium under Part 5.3A for:

- bankers' liens
- shares lodged as collateral with any recognised clearing house.

RECOMMENDATION 26

The court's power to grant an injunction against enforcement action by a chargee over particular property, on application by an administrator, should be extended to cover injunctions against threatened enforcement actions.

RECOMMENDATION 27

Chargeholders who are permitted by the Corporations Law to enforce their charges should be able to do so during the administration period through court enforcement, as well as extra-curial, action.

Deeds of company arrangement

RECOMMENDATION 28

The court power to bind secured creditors or owners or lessors of real or personal property to a deed of company arrangement should only be exercisable after the creditors have resolved that a deed of company arrangement be executed.

RECOMMENDATION 29

The prescribed provision dealing with making claims should be amended by:

- adding the words "with such modifications as may be necessary";
- stating that a reference to "the relevant date" means a reference to the date of the administrator's appointment;
- referring to the regulations which deal with proof of debt procedures in a liquidation.

RECOMMENDATION 30

The prescribed provision dealing with priority payments under a deed of company arrangement should incorporate all the priority provisions, not just s 556.

RECOMMENDATION 31

The prescribed provision dealing with meetings should be deleted.

RECOMMENDATION 32

The prescribed provisions should provide for, rather than require, the establishment of a committee of inspection.

RECOMMENDATION 33

A company should have an express right to apply to the court for an order that the company need not include the words "subject to deed of company arrangement" on its public documents.

RECOMMENDATION 34

It should be made clear that a debt which is extinguished by entry into a deed of company arrangement, and which by its terms would have otherwise survived, is deemed not to have been extinguished for the purpose of enforcing a related guarantee or indemnity.

RECOMMENDATION 35

Any deed of company arrangement should only terminate:

- through a resolution of creditors following a material breach of the deed that has not been rectified before the resolution is passed
- in circumstances contemplated by the deed itself, or
- by an order of the court, on application by a creditor of the company, the company, or any other interested person. The court, in deciding whether to terminate a deed, should be required to take into account the rights of third parties.

Administrators and deed administrators

RECOMMENDATION 36

All administrators (whether appointed under s 436A, 436B or 436C) should be required to table a statement of interest at the first meeting of creditors. The statement should disclose any professional, personal and business relationships of the administrator and his or her firm with the company or its officers, members or creditors that the administrator knew or should have discovered upon reasonable inquiry, including as an accountant or other professional adviser (other than the relationship arising merely from the company's request that the person be an administrator).

RECOMMENDATION 37

The administrator of a company should be permitted to consent to a transfer of shares in the company or an alteration in the status of the company's members if such a transaction is, in the administrator's opinion, in the best interests of the creditors of the company. The court should continue to have the power, on application by the prospective transferor or transferee of the shares, to consent to a transfer of shares or an alteration in the status of a company's members. An application to the court should only be permissible where the administrator has refused to consent to the transfer.

RECOMMENDATION 38

Administrators should be able to obtain approval of their fees:

- by agreement between the administrator and the committee of creditors

- by resolution of creditors generally where they have notice that this matter is to be considered, or
- by the court.

If a meeting of creditors is convened for this purpose after the administration has concluded, the cost of the meeting should be an expense of the administrator personally, without any right of indemnity out of the company's property.

The administrator's report to creditors should include a disclosure of the administrator's past and projected fees and expenses.

RECOMMENDATION 39

Administrators should continue to be personally liable for debts incurred in the performance or exercise of any of their functions and powers.

RECOMMENDATION 40

An administrator should not be taken to have adopted any employment contract entered into by the company unless the administrator does so expressly in writing. It should be made clear that any adoption of an employment contract only relates to entitlements that accrue during the period of the administration. Any Federal, State or Territory legislation relating to employment contracts that is inconsistent with this recommendation should be overridden.

An administrator of a company should be personally liable for the wages of the company's employees who continue to provide services with the administrator's express or implied authority. An administrator should not be taken to have given implied authority for the provision of services by an employee of whom the administrator was unaware, provided that the administrator has taken all reasonable steps to identify all the company's employees.

RECOMMENDATION 41

An administrator's right of indemnity should cover any personal liabilities incurred by an administrator in the due performance of the administrator's duties, other than liabilities incurred in bad faith or negligently.

RECOMMENDATION 42

Deed administrators should only have a power to sell existing shares in the company either with the prior approval of the holder of those shares or with the leave of the court. Members, creditors and the Commission should have standing to oppose a court application for leave.

RECOMMENDATION 43

Administrators and deed administrators should be required to lodge with the Commission accounts of receipts and payments.

Winding up proceedings prior to an administration

RECOMMENDATION 44

The court should have the power, on application by a creditor of a company, to make an order appointing an administrator to that company.

RECOMMENDATION 45

The Corporations Law should explicitly provide that the directors of a company to which a liquidator or provisional liquidator has been appointed cannot appoint an administrator.

RECOMMENDATION 46

The Corporations Law should explicitly provide that a charge over all or substantially all the property of a company to which a liquidator or provisional liquidator has been appointed cannot appoint an administrator.

RECOMMENDATION 47

A liquidator should be entitled to appoint himself or herself as administrator with the approval of the creditors of the company, or with the leave of the court.

RECOMMENDATION 48

The leave of the court or the approval of creditors should be required for a liquidator or provisional liquidator to appoint his or her business partner, employee or employer as administrator of a company.

RECOMMENDATION 49

A deed administrator should have the right to apply to the court for an order terminating a winding up. In determining that application, the court should be directed to have regard to:

- any misconduct of the company’s officers reported by the administrator, the liquidator or the Commission;
- the commercial decision of creditors in accepting the deed of company arrangement;
- whether the deed of company arrangement would leave the company insolvent, and
- such other matters as the court thinks fit.

RECOMMENDATION 50

In addition to the Commission, a creditor or a member of a company, a liquidator or provisional liquidator who has put the company into administration should have the right to apply to the court for replacement of an administrator.

Liquidation following an administration

RECOMMENDATION 51

Transactions that take place during the course of a voluntary administration (including during the administration of a deed) that precedes any form of court or voluntary winding up, other than:

- transactions performed by or with the authority of an administrator or a deed administrator (even if in fact performed by the directors)
- transactions that are specifically authorised by a deed of company arrangement and carried out by the administrator of that deed

should be subject to the voidable transaction provisions.

RECOMMENDATION 52

Where:

- a company goes into liquidation after a voluntary administration
- an application for winding up has been made before the commencement of the administration, and
- the winding up application has not been dismissed

the relation-back day should be the day on which the application for the winding up order was filed (regardless of whether the company is wound up by virtue of that application), not the date of the appointment of the administrator. Dispositions by the administrator are not to constitute voidable dispositions.

RECOMMENDATION 53

The officer in control of a company under administration, or under a deed of company arrangement, immediately before the company proceeds into liquidation should be required to lodge with the Commission, at the time the company goes into liquidation, the s 439A report and a further report on:

- any matters not referred to in the s 439A report, and/or
- any material changes to matters referred to in that report

- which affect the financial position of the company and of which that person has become aware before the date of the further report.

RECOMMENDATION 54

Creditors should have the right to appoint their own nominee as liquidator when a company under administration goes into winding up. If creditors do not appoint their own nominee, the administrator or deed administrator should become the liquidator.

RECOMMENDATION 55

Where a liquidation follows a deed of company arrangement, post-deed creditors should have no statutory priority, except where the deed administrator is personally liable for debts covered by s 556(1)(a).

Creditors voting at the major meeting should have the right to include in a deed of company arrangement any other form of priority for post-deed creditors.

The current priority rights for debts incurred by administrators should remain.

RECOMMENDATION 56

Creditors' voluntary winding up should be abolished.

Implications for takeovers and fundraising

RECOMMENDATION 57

There should be no exemption from the takeover provisions for an acquisition of shares pursuant to a voluntary administration.

RECOMMENDATION 58

There should be an exemption from the fundraising provisions for offers or invitations to creditors to exchange debt for equity under a deed of company arrangement.

Other matters

RECOMMENDATION 59

All references to days in Part 5.3A should be to "business days".

RECOMMENDATION 60

Any company that changes its name during the course of, or in the 6 months before, a voluntary administration should be required to disclose its former, as well as its current, name on its public documents for the period of that administration or any subsequent liquidation.

APPENDIX 4

OBJECTIVES OF INSOLVENCY LAW

The Cork Report

The Cork Report provides much of the policy rationale for UK insolvency law. The objectives of a good modern insolvency law identified by the Cork Report (as succinctly summarised by one commentator[1]) were:

- To underpin the credit system and cope with its casualties;
- To diagnose and treat an imminent insolvency at an early, rather than a late stage;
- To prevent conflicts between individual creditors;
- To realise the assets of the insolvent which should properly be taken to satisfy debts with the minimum of delay and expense;
- To distribute the proceeds of realisations amongst creditors fairly and equitably returning any surplus to the debtor;
- To ensure that the processes of realisation and distribution are administered honestly and competently;
- To ascertain the causes of the insolvent's failure and, if conduct merits criticism or punishment, to decide what measures, if any, require to be undertaken; to establish an investigative process sufficiently full and competent to discourage undesirable conduct by creditors and debtors; to encourage settlement of debts; to uphold business standards and commercial morality; and to sustain confidence in insolvency law by effectively uncovering assets concealed from creditors, ascertaining the validity of creditors' claims and exposing the circumstances attending failure;
- To recognise and safeguard the interests not merely of insolvents and their creditors but those of society and other groups in society who may be affected by the insolvency, for instance not only the interests of directors, shareholders and employees but also those of suppliers, those whose livelihoods depend on the enterprise and the community;
- To preserve viable commercial enterprises capable of contributing to national economic life;

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1 Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles,* Cambridge Uni Press, (2002), pp 26-27.

- To offer a framework of insolvency law commanding respect and observance, yet sufficiently flexible to cope with change, and which is also seen to produce practical solutions to commercial and financial problems, simple and easily understood, free from anomalies and inconsistencies and capable of being administered efficiently and economically;
- To ensure due recognition and respect abroad for English insolvency proceedings.

New Zealand Insolvency Law Review

Since 2000 New Zealand has undertaken a comprehensive review of its insolvency laws and underlying policies. The objectives of insolvency law that the review chose to particularise were:

- To provide a predictable and simple regime for financial failure that can be administered quickly and efficiently, imposes the minimum necessary compliance and regulatory costs on its users, and does not stifle innovation, responsible risk taking and entrepreneurism by excessively penalising business failure;
- To distribute the proceeds to creditors in accordance with their relative pre-insolvency entitlements, unless it can be shown that the public interest in providing greater protection to one or more creditors (statutory preferences) outweighs the economic and social costs of any such preference:
- To maximise the returns to creditors by providing flexible and effective methods of insolvency administration and enforcement which encourage early intervention when financial distress becomes apparent;
- To enable individuals in bankruptcy again to participate fully in the economic life of the community by discharging them from their remaining debts in appropriate circumstance; and
- To promote international co-operation in relation to cross-border insolvency.

In association with this review the NZ Law Commission's *Advisory Report to the Ministry of Commerce, Insolvency Law Reform: Promoting Trust and Confidence*, provides valuable insights into the underlying policies influencing insolvency law from a NZ perspective and the role to be played by the State in insolvency law.[2] The Commission highlighted that an overriding theme was the need to instil trust and confidence in a country's insolvency law system so that insolvency law can act as a

2 New Zealand Law Commission, Insolvency Law Reform: Promoting Trust and Confidence, An Advisory Report to the Ministry of Commerce, March 2001. The Report may be viewed at http://www.lawcom.govt.nz/.

pillar for both fiscal and social policy decisions.[3] In its report the Law Commission placed emphasis on two public policy factors which insolvency law ought to address, reduction of the cost of credit and promotion of entrepreneurship.[4]

3 Preface, p 7.

4 Advisory Report to the Ministry of Commerce, p 37.