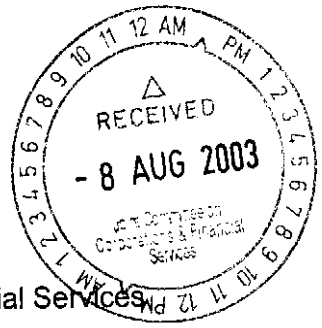
5 August 2003



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Dr Kathleen Dermody
Secretary
Joint Committee on Corporations and Financial Services
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By email: frank.donnan@aph.gov.au & by mail

Dear Dr Dermody

Inquiry into Australia's Insolvency Laws

In CPA Australia's submission dated 7 February 2003, I foreshadowed providing the Joint Committee on Corporations and Financial Services with a supplementary submission. That supplementary submission is attached and addresses the following matters:

- receiver's remuneration;
- assetless companies;
- phoenix companies;
- ASIC prosecutions;
- voidable transactions;
- voluntary administrations;
- Superannuation Guarantee Charge;
- GEERS;
- employee entitlements – maximum priority rule;
- retention of title; and
- merger of insolvency laws.

I note that CPA Australia's 7 February 2003 submission and the attached supplementary submission are separate from Submission No. 37, which was prepared by the Legislation Review Board administered by the Australian Accounting Research Foundation. The Foundation is jointly funded by CPA Australia and the Institute of Chartered Accountants in Australia.

If required, CPA Australia is willing to provide the Committee with additional information. Questions concerning the supplementary submission should be directed to Mr John Purcell, Business Policy Adviser on Tel: (03) 9606 9826 or Mr George Lopez, Chairman, CPA Australia's Centre of Excellence on Insolvency and Reconstruction on Tel: (08) 9328 3500.

Yours sincerely

Greg Larsen, FCPA
Chief Executive
CPA Australia

cc: G Lopez, J Purcell, K Lewis, T Rowe

CPA Australia

SUPPLEMENTARY SUBMISSION TO THE JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

INQUIRY INTO AUSTRALIA'S INSOLVENCY LAWS

28 July 2003

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List of acronyms and abbreviations

ASIC	Australian Securities and Investments Commission
DEWR	Commonwealth Department of Employment and Workplace Relations
GEERS	General Employee Entitlements and Redundancy Scheme
ROT	Retention of Title
SGC	Superannuation Guarantee Charge

1. Introduction

1. This is a supplementary submission made by CPA Australia to the Joint Committee on Corporations and Financial Services for its Inquiry into Australia's insolvency laws. CPA Australia's first submission is dated 7 February 2003 and is Submission No. 23.

2. The matters addressed in this supplementary submission are:
   - receiver's remuneration;
   - assetless companies;
   - phoenix companies;
   - ASIC prosecutions;
   - voidable transactions;
   - voluntary administrations;
   - Superannuation Guarantee Charge;
   - GEERS;
   - employee entitlements – maximum priority rule;
   - retention of title; and
   - the merger of insolvency laws.

2. Receiver's remuneration

3. One area of significant concern for unsecured creditors is the level of and accountability for, receivers' remuneration. In any other form of external administration the liquidator, administrator or trustee is required to seek approval from creditors in respect of his fees. Inherent in that is the requirement that the external administrator provides details of the tasks performed and the remuneration charged for time spent. In the event those fees are not approved by creditors, the external Administrators may make application to the courts for approval.

4. The exception is when a receiver is appointed by a secured creditor. In that situation, his remuneration is subject to approval only by his appointor. The receiver is only primarily responsible to his appointor and only has secondary or indirect responsibility to the other creditors and to shareholders. That responsibility is interpreted as a duty of care, to ensure that he acts in good faith, realises assets at market value or at the best price reasonably obtainable. 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.

5. 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 costs and charges of the receivers and a perception is that once receiver has been 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.

6. There is a perception that some secured creditors, mainly the banks, are only concerned to scrutinise the receiver's fees until the secured debt has been

satisfied. Instances are reported wherein banks negotiate fee levels with the receivers on the understanding that the fee restrictions only apply while the secured debts have not been fully satisfied.

7. Accordingly, as a rule, and especially when the secured debt has been satisfied, receivers are not held accountable for their fees.

8. There is a further perception (although unsupported by evidence) that some receivers will ensure that there are no funds remaining when they have completed their administrations. They, in effect, have engineered a situation creating an assetless company. Without funds, the likelihood of a practitioner willing to take on the liquidation of the company is slim, and in the event liquidation does transpire, with insufficient funds, there is less likely to be investigation into the receiver's activities.

9. A review of the insolvency laws should address the question of approval of receivers' fees and provide for a mechanism whereby those fees may be scrutinised by ordinary unsecured creditors or the courts.

3. Assetless companies

10. 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 only to perform minimal tasks in order to attain early finalisation. Under section 545, with the exception of certain reports, a liquidator is not compelled to incur any expense in the winding up of a company.

11. In effect this means that rogue directors could (and do) ensure that before taking steps to have companies wound up, they strip the company of its assets (by Phoenix-type operations or other means) to ensure that minimal investigation and recovery action is likely to occur in the event the company is placed into liquidation.

12. There are organisations that will fund actions by Liquidators to recover assets. These organisations which are commonly (but not always) insurance companies, charge a very high premium for the service, cognisant of the risk that recovery may not eventuate. In recognition of that risk, before the services and assistance of these companies can be contemplated, a Liquidator must have conducted detailed investigation and submitted an application for assistance which will include, inter alia, detailed description and justification for the funding. This requires the liquidator to take significant financial risk himself to conduct the investigation. In reality, in many cases, that does not occur.

13. The Harmer-led Australian Law Reform Commission recommended a fund, financed by a levy on all companies, which could be used towards funding such assetless administrations to enable at least a basic level of investigation to be undertaken. While CPA Australia understands the reluctance of companies to pay yet another impost, that needs to be weighed against the cost, to society and to the economy, of insolvency generally and corporate fraud specifically.

14. If a levy against all companies is too politically unpalatable, the government ought to consider providing such funding itself.

15. Section 305 of the *Bankruptcy Act 1966* provides a facility for funding, by the Commonwealth of enquiries and investigation by the Trustee and if appropriate, funding for certain legal recovery action. In the absence of a Fund for Assetless companies, the same process as occurs in bankruptcy may be another means of achieving the same purpose.

4. Phoenix companies

16. 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.

17. It is apparent that the problem in both cases is one of funding:
    - lack of funding leading to an under-resourced ASIC and
    - lack of assets being the main reason for under-investigation and follow up legal recovery action by the liquidators (assetless companies).

18. From that viewpoint, the continuing problem will only be resolved by addressing and rectifying the problems of funding.

19. However, CPA Australia believes 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.

5. ASIC prosecutions

20. 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.

21. 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.

22. This is unfortunate and the ASIC has blamed lack of sufficient resources for this problem. To some extent, that is understood, given the budget cuts in the investigation areas, however, even with increased budget input, the physical resources of the ASIC are unlikely to be sufficient to prosecute the multitude of offences that occur with insolvent companies.

23. Another strategy may be to provide a facility for liquidators to be deputised to mount the prosecution of offences against delinquent directors, under the ambit of the ASIC. This makes a lot of sense as the external administrators are more familiar with the books and records and the activities of the company and thus, are in a better position to assist legal counsel.

6. Voidable transactions

6.1 Uncommercial transactions

24. The Corporations Law as it currently stands, only allows recovery of uncommercial transactions where the transaction was also an insolvent transaction, that is, it occurred when the company was insolvent. This is a relatively recent requirement and differs from the previous situation which was based on s120 of the Bankruptcy Act.

25. Some hold the view that an uncommercial transaction is just that and should be voidable as against a liquidator regardless of the company's solvency. Insolvency is not necessarily caused by a single event, but is often attributed to by a series of events, not necessarily related. Even if an uncommercial transaction does not, by itself, cause insolvency, it may be argued that, if the company had not entered into that transaction, it may have had greater assets at its disposal to prevent a future insolvency.

26. Perhaps a reversion to the provisions similar to s120 of the Bankruptcy Act, may be more appropriate.

6.2 Recovery actions

27. Especially with assetless companies, a liquidator may not be able to recover assets where voidable transactions have occurred, especially where the sums to be recovered are insufficient to obtain funding from third parties, or the legal costs of so doing may be prohibitive.

28. In these cases, some streamlining of the processes to make prosecutions simpler, quicker and less costly, as exists with the Bankruptcy Act (s.139ZQ), may improve the situation.

7. Voluntary administrations

7.1 Contracts

29. In CPA Australia's original submission, it was recommended that there be a higher level of protection for Voluntary Administrators from the actions of receivers.

30. CPA Australia believes that level of protection should also be extended to ensure that Administrations are protected from ANY party that is in a position to destroy or threaten the future of the company while in the moratorium period.

31. In that regard, especially where a company's main source of income is in the contractual field, (construction, engineering, leasing, etc) contracts often give the other party to the contract the right to, unilaterally, terminate the contract upon some event of insolvency.

32. If the other party is in a position to terminate the contract without reference to the Administrator, then the whole purpose of placing a company into Voluntary

Administration is defeated, notwithstanding the wishes of its creditors who, the legislation intends, should decide the future of the company.

33. While CPA Australia acknowledges that, in some cases, it may be imperative that the other party should be able to protect its own interests ahead of that of the company, providing that the contract may only be terminated with the permission of the Administrator or the Court should adequately provide that protection.

7.2 Allow creditors appoint administrators

34. At present, the only parties who may place a company into administration are the directors, a secured creditor or a liquidator.

35. There may be situations where the directors, who may be the only persons in a position to do so, are either unwilling to place the company into administration or may themselves be in dispute. Creditors whose debts are unsatisfied should have a facility, similar to that under Part 5.4, to place a company into Voluntary Administration.

8. Superannuation Guarantee Charge

36. While CPA Australia supports the SGC legislation as a means of enforcing contributions by companies, we believe that it has not been as successful as it could have been. The lack of supervision and monitoring is the prime reason for the inadequacy of the system and while the conversion from annual payment to quarterly payments should improve matters, a system of inspection of those entities which are late or fail to lodge returns is recommended.

37. When financial difficulties are experienced, payment under any system that requires payment based on information provided by the payer (self assessment) is most likely to be deferred unless it is monitored and promptly followed up.

8.1 Clarification

38. The legislation is not altogether clear as to whether, the SGC actually takes the place of Superannuation or is in addition to it. If in addition to it, is there a double-dip, in effect, two claims for the same amount?

39. If it simply replaces superannuation, does it change its nature from wages? Superannuation already has priority, being defined as wages in s556(1)(e) of the Corporations Act and in the most recent inclusion of s109(1B) of the Bankruptcy Act.

40. The matter is significant in the corporate arena as under present legislation, directors of companies and their relatives are limited as to the amounts they may claim for wages and holiday pay as a priority. If the SGC is not deemed to be wages, then, in effect, they are no longer limited and conceivably, are better off under the SGC, being entitled to an unlimited priority claim under the SGC.

8.2 Inconsistency

41. When a company enters into liquidation, the SGC receives a priority equivalent to that of wages. However, this priority does not apply to any other form of external administration, neither does it apply in matters of personal insolvency.

42. There can be no logical reason why employees of a business owned by a partnership or sole proprietor (as opposed to a corporate entity) should be disadvantaged.

8.3 Provability

43. Situations often arise wherein no SGC claim exists when a company goes into liquidation but due to the time delays in recovering funds and payment by the liquidator, the SGC claims then arises in the course of the liquidation.

44. With only minor exceptions, in insolvency law, the only debts which are provable are debts which exist prior to the relevant date. The question that arises then is if the SGC does not exist as at the date of liquidation but only arises in the course of liquidation, is it a provable debt at all? If not, then regardless of its priority ranking, it is not payable.

45. This requires clarification.

8.4 Fairness

46. Further questions arise as to the fairness of the SGC when a company is in liquidation. As a means of punishing delinquent employers by penalising them for failure to pay by the due date, the system has merit.

47. The same cannot be said, however, when a company becomes insolvent. By increasing the company's liability and enhancing its priority, the penalty really disadvantages the ordinary unsecured creditors of the company by decreasing their potential return. These creditors are innocent bystanders who themselves are likely to suffer losses as a consequence of the liquidation.

48. CPA Australia believes the equity of such an arrangement seriously needs review.

9. GEERS

49. The General Employee Entitlements and Redundancy Scheme (GEERS) has no legislative backing and that is of concern. As such, its administration appears subject to the whim of officers in the Department of Employment and Workplace Relations (DEWR) and has resulted in some anomalies and inequities in the system.

50. A little publicised aspect of the GEER Scheme is that the entitlement only arises if employees are terminated because of a formal appointment. This arises out of the definition of an insolvent entity. Accordingly, where employees have been

has been effected, the employees have been advised that they are not entitled to payment under the scheme.

51. While this may strictly be correct under current interpretation of the rules of operation, one has to query whether this is really in accordance with the spirit of the scheme. An employer trying to avoid trading while insolvent may terminate his employees before entering into formal external administration and thus, may actually be prejudicing his employees' entitlements by doing so.

52. On another issue, there have been instances where DEWR has held off paying the employee entitlements until the outcome of a Deed of Company Arrangement is known. Only when the Deed has failed or is clearly not going to generate sufficient to cover employee claims are the funds being released. While this cautionary approach is understandable, CPA Australia questions whether if it is consistent with the goals of GEERS, that is, to provide an early return to employees.

53. Where a company has absolutely no funds and employee entitlements are being funded under the GEERS, the external administrator may require funding to do the work necessary to validate the claims. In such circumstances, GEERS will fund the validation process. While this is useful, the funding does not often extend to covering the real costs of validation and a process of negotiation often ensues between the scheme administrators and the external administrator. While this is occurring, time is being lost, to the employees' detriment.

54. Another situation that may arise occurs when there is some doubt as to whether a claim is valid. In some circumstances, legal opinion may be required, but GEERS is not willing to pay for that legal opinion. In that situation, the external administrator may have little choice but to leave the decision on the payment to GEERS. If GEERS then makes the payment, a situation may arise when funds eventually do become available, that the external administrator may not admit that particular claim.

55. Similarly, situations have arisen when the external administrator has advised against paying a claim or portion of a claim, but the GEERS staff sometimes still elect to pay. Again, this may become a problem if funds subsequently become available and the employee's claim is rejected.

56. Under present procedures, the employee submits his claim directly to GEERS. The external administrator may not be aware which claims have been submitted to GEERS. GEERS then remits funds to the external administrator, who deducts tax and pays the employee. The present process appears to be a little long winded and time consuming and perhaps, streamlining the process so that GEERS pays the employees directly may be a more satisfactory process.

10. Employee entitlements – maximum priority rule

57. Previously CPA Australia has written to the Treasurer, expressing views on the intended maximum priority legislation. These views are repeated here.

58. The proposal to elevate the status of employees ahead of secured creditors, subject to fixed charge securities, still prejudices the rights of "innocent" parties instead of attacking those who often are the source of the problems, the directors themselves. Not all secured creditors are banks.

59. Perhaps there ought to be legislation removing the corporate veil and the limited liability protection that directors seem to enjoy today, notwithstanding the penalty provisions of the Corporations Law.

60. In that regard, the Corporations Law provides significant legislative protection making directors personally liable for debts incurred while a company is insolvent, however, the policing of the legislation is very poorly handled at present.

61. For example, two mechanisms which could go a long way to punishing offenders and ensuring that insolvent companies are brought to account a lot sooner are the investigation sections of the Australian Securities & Investments Commission and the Default Sections of the Australian Taxation Office.

62. In addition, the Corporations Law requires that the company be in liquidation before action can be taken. Perhaps, other types of administration should also be brought into the fold.

63. In terms of the legislation itself, security needs to be defined as to whether it is simply restricted to fixed charge debentures or whether it includes other forms of security such as liens, Garnishee Orders, Income Tax Assessment Act Section 218 Orders, statutory liens, leases, hire purchase agreements and sub-contractor liens.

64. CPA Australia is concerned that small business will find it more difficult to borrow funds from banks, interest rates will go up as a consequence of the banks reduction in security and banks may be less tolerant in times of minor liquidity crisis.

65. The perception has been, in recent times, that some banks have adopted an unfeeling attitude towards clients, even in cases where the client business itself has met all the bank's requirements, but happens to be in an "undesirable" industry. Also, where there is any slight indication of a liquidity problem, the banks tend to abandon that client, call in their overdraft and force them to go elsewhere.

66. This places the client in a very difficult position as, at that stage, it is in probably its worst position when trying to obtain funding from another bank and in many cases, formal insolvency is the resultant outcome.

67. These changes will only exacerbate that situation although, some would say, the quicker inefficient businesses are weeded out of the system the better.

68. The time delays between the introduction of the concept and the legislation taking effect could see a rush by banks to create charges over client assets so that they take effect prior to the changes in legislation.

69. The proposal contemplates some form of clawback arrangement in the event of charge holders enforcing the charge within six months of liquidation and may, in certain circumstances, be unfair to the secured creditors themselves.

70. For example, a secured creditor could conceivably enforce its charge to find that it may have to disgorge contributions in respect of employee entitlements which did not exist at the time it realised its security but which came into being after that event.

71. Examples of that would be wages and holiday pay entitlements accrued after the realisation of security, proportionate long service leave which may not have been

due at the time of the realisation of security and, of course, pay in lieu of notice which would not have been and could not have been accrued, but only came into effect because the business subsequently ceased operation.

72. In conclusion, CPA Australia is of the view that the intended legislation will be no more than a band-aid solution, 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.

11. Retention of Title

73. Retention of Title (ROT) clauses seek to retain ownership, by the suppliers, in goods that have not been paid for. They are specifically designed to allow the supplier to either recover the goods or receive guarantee of payment in the event of external administration.

74. CPA Australia is of the view that there are two issues that should be addressed in relation to ROT clauses.

75. First, the inclusion of stock subject to ROT in balance sheets is very misleading if, in effect, title in the goods is retained by the supplier. Directors and external administrators may make decisions based on accounting information provided, only to discover material reductions to the actual level of assets available. CPA Australia believes that the accounts should disclose the level of stock subject to ROT. Not to do so is, in effect, a misrepresentation of the actual position.

76. While CPA Australia understands the difficulties disclosure may cause in establishing - which creditors are claiming ROT, the validity of those claims and the specific goods to which the ROT clause applies, CPA Australia is of the view that any information is preferable to the current situation wherein no disclosure at all is made.

77. There are suggestions that a register of ROT clauses be maintained. CPA Australia would support this approach, however, recognises that problems exist in such an approach as well.

78. Consideration ought to be given to whether the ROT clause is registered in respect of each supplier or in respect of each account. Registration of each account could result in an unwieldy registration system which could involve possibly hundreds of thousands of registrations, given the number of purchasers and suppliers to each purchaser.

79. On the other hand, registration of the suppliers will certainly reduce the number of registrations, but will still result in a significantly large data base of registrations. Also, the cost of registration may be prohibitive, especially where quantities supplied are insignificant or for "one off" supplies and registration does not necessarily validate the ROT clause.

80. CPA Australia understands that registration legislation has been in operation in New Zealand for just over one year and it may be useful to examine the efficacy of that legislation.

12. Merger of Insolvency Laws

81. Much of Australia's insolvency law sees parallels and similarity between the Corporations Act and the Bankruptcy Act. On the other hand, some of the law has seen a divergence in direction. This divergence can lead to some confusion as to application. It also increases the costs of education and training of insolvency practitioners and in that regard, indirectly adds to the cost of administrations.

82. CPA Australia sess no logical reason that similar situations should be treated differently and have different outcomes where the only difference may be that one enterprise is owned by a corporate entity and the other by individuals either solely or in partnership.

83. Accordingly, CPA Australia sees merit in merging the insolvency laws to achieve consistency of application.

84. CPA Australia recognises that there are a great many issues to be addressed in such a major undertaking. To list all these issues and to explain in sufficient detail the current effects of each and the benefits of change are beyond the capacity of an organisation whose members contribute to intellectual capital on a voluntary basis.

85. A system of prioritisation must, and has taken place resulting in this and our previous submission to the Committee's Inquiry.