

Submission in Response to Productivity Commission Draft Report - Business Set-up, Transfer and Closure – 21 May 2015

1. Introduction

- 1 This Submission is made by the Insolvency & Reconstruction Law Committee and the Corporations Committee of the Business Law Section of the Law Council of Australia (“the **Committee**”).
- 2 Contact details for persons able to speak to the Submission appear in Section 4 below.

2. Summary

- 3 The Productivity Commission (**Commission**) has released a Draft Report in relation to its inquiry into Business Set-up, Transfer and Closure dated 21 May 2015 (**Draft Report**) and called for further submissions to be provided by 3 July 2015. The Committee provides this submission in response to the Draft Report and particularly Chapters 13, 14 and 15 which address personal and corporate insolvency.
- 4 The Committee largely supports the recommendations of the Commission particularly in relation to the introduction of a safe harbour mechanism (Recommendation 15.2) and the voiding of “*ipso facto*” clauses upon insolvency (Recommendation 15.4). The Business Law Section of the Law Council of Australia has previously supported such changes. In this regard the Committee refers to its previous submissions made March 2010, 20 February 2015 and 18 March 2015.
- 5 The Committee comments separately on each of the relevant Draft Findings and Recommendations below.

3. Personal Insolvency

- 6 AFSA administers the vast majority of all bankruptcy administrations, the majority of which are colloquially referred to as “consumer” or “non business” bankruptcies”. The regulatory burden under the *Bankruptcy Act 1966* (**Act**) of administering these bankruptcies, consistent with the obligations under the Act, is significant¹. The Draft Report does not

¹ The utility of expressions such as “consumer” bankruptcy is questionable. There is no such distinction drawn within the Act. Equally the Act does not distinguish the role of the Official Trustee in Bankruptcy as being any different to that of Registered Trustees – see generally *Adsett v Berlouis* (1992) 37 FCR 201.

By way of example the Act requires all bankrupts to provide a statement of income within 21 days after the end of the relevant assessment period – section 139U, and for the trustee to conduct an assessment of income liability after the start of each assessment period. A failure to provide particulars of income information is a ground

comment on the need for such “consumer” bankruptcies to be administered in the same manner as “business” bankruptcies and whether in fact that occurs. To the extent there is a perception that “consumer” bankruptcies are administered differently to business bankruptcies can undermine public confidence in laws but can also lead to the encouragement of avoidance behaviour as debtors seek to take advantage of perceived differences in the way bankruptcies may be administered.

- 7 Recommendation 13.1 provides for the duration of bankruptcy being reduced to 1 year subject to it otherwise being extended by way of objection to discharge from bankruptcy.
- 8 The Committee has reservations on the reduction of the period of bankruptcy and does not support the Recommendation. The ability of a trustee to demand the co-operation of a bankrupt is practically far simpler while the person remains a bankrupt. The Committee would prefer to see the concept of “early discharge” being revisited with a more accessible and efficient model in this regard being implemented.
- 9 The suggestion that three years of bankruptcy discourages entrepreneurial behaviour is not supported by evidence. Given the vast majority of bankruptcies are consumer in nature the number of “entrepreneurs” within the pool of bankrupts that society might wish to encourage is likely limited. Whether such far reaching changes ought be made for some unquantified pool of perceived entrepreneurial talent is questionable. Equally there is no evidence that our bankruptcy laws discourage entrepreneurs in the first place.
- 10 Notwithstanding these comments, the duration of bankruptcy being reduced to 1 year, subject to there being an ability to extend, may go some way to addressing perceptions of discrimination as to the manner in which “consumer” bankruptcies are administered as opposed to “business” bankruptcies. Such amendment however should be recognised as addressing economic factors going to the cost of administering the vast bulk of bankruptcy administrations as opposed to some concept of suppression of entrepreneurial behaviour. However regulatory concerns as to the administrative cost of “consumer” bankruptcy might equally be addressed through a more efficient early discharge model.
- 11 If there was to be a reduction of the period of bankruptcy then it should be done in conjunction with an overhaul of the objection to discharge provisions to ensure in appropriate cases the period of bankruptcy can be extended efficiently. There is a material risk to trustees and the estate in that they will be required to bear the cost of lodging objections and the costs of review and appeal by the bankrupt to ensure the integrity of the bankruptcy system is maintained.
- 12 The Committee otherwise continues to support the greater unification of corporate and personal insolvency laws.

(continued...)

of objection (see s.149D(1)(e) and a trustee is under a positive obligation to file an objection if to do so will help encourage the bankrupt to discharge his or her obligation. The extent to which these positive obligations under the Act are met with respect to consumer bankrupts is not commented upon in the Draft Report.

4. Corporate Insolvency

- 13 The Committee supports the conclusions reached in Draft Finding 14.1. The Committee does not consider there is a need for the incorporation of a United States based Chapter 11 model for corporate re-organisation. Rather the introduction of a safe harbour model is considered a better model for addressing corporate re-organisation prior to insolvency.
- 14 The Committee supports the conclusions reached in Draft Finding 14.2. In saying this however it is recognised that Part 5.3A of the *Corporations Act 2001 (CA)* continues to have a role to play as a restructuring mechanism.
- 15 The Committee opposes Recommendation 15.1. Voluntary Administration can provide real economic benefits to stakeholders through insolvent reorganisations which would not be available in a winding up of the affairs of the company. The compromising of stakeholder rights in this forum should be left for the informed decision of those stakeholders. While it is accepted that Part 5.3A can, like any laws, be subject to abuse that is not a basis to remove its benefits entirely. Having regard to the history of operation of Part 5.3A there is no warrant to limit it in the way suggested.
- 16 While the Committee supports Recommendation 15.2 there continues to be disparate views as to the model to be adopted.

As to the model to be adopted we make the following comments:-

- While the ARITA proposal mirroring the business judgment rule in s180 of the Act has some attractions, it will likely be complex and hard to make out. The effectiveness of this defence to date must be questioned and it seems likely that directors would continue to have reservations as to its utility as a defence to an action under s588G.
- The Committee is concerned about the need to disclose the appointment of an insolvency adviser to the ASX or ASIC, because the announcement may, of itself, have a detrimental impact on the company. That said ASX listed entities will continue to have disclosure obligations.
- The Committee is concerned in the third dot point of 15.2 of the reference to the directors' 'business judgment'. Since the decision in Fortescue, directors have expressed concern that their actions might be determined by the court not to be 'business' related, which means that if they have not exercised a 'business' judgment, the defence may cease to be available to them. Accordingly it would be preferable to delete the word 'business', as nothing really seems to turn on it.
- In the third dot point there is a reference to a duty to creditors. Care consideration needs to be given to concepts of director duties towards creditors. The law as it presently stands is that the company is to take into account the interests of creditors at a time when it is approaching insolvency. If there is to be any statutory reformulation of this duty then it should be subject of express reference.

- There has been a continued extension of director exposure to liability under taxation and other laws² in recent years. Consideration should also be given to any safe harbour being extended to liability under those laws as well.
 - The Committee acknowledges the need for a limitation on the time during which the directors can avail themselves of the safe harbour, and suggest 90 days as a reasonable period subject to extension upon application to the Court.
 - Consideration should be given to the defence only being available at least once every 2 years (rather than the suggested 3).
 - Australia's insolvent trading regime is already the toughest in the Western economies. The Committee sees no reason to make it any easier to prove insolvent trading, and do not support a proposal to make insolvent trading 'simpler to prove'. Already there is an obligation on directors to act if they have reasons to suspect - not expect, that a company is insolvent, which is a reasonably low bar in any event.
- 17 The Committee supports the sentiment behind Recommendation 15.3 in that transferees of assets will require certainty of outcome as a result of any safe harbour reorganisation. However this might be better addressed though creating a defence to an action from liquidator that the transaction was undertaken as part of a bona fide re-organisation that was not otherwise in breach of the director's duties. This would be consistent with the insolvent trading limitations. The Liquidator should still otherwise have to prove a case under the present regime.
- 18 The Committee supports Recommendation 15.4 and the voiding of *ipso facto* clauses as part of any administration under Part 5.3A of the CA. Consideration may need to be given to ensuring adequate protections to suppliers trading with what will ordinarily be an insolvent entity in administration³.
- 19 The Committee does not support Recommendation 15.5 and the introduction of a split model that separately addresses "small" liquidations. There is a concern that the creation of a separate administration may create distortions in the market as parties try and take advantage of perceived benefits in being subject to administration as a "small liquidation". In this regard any system that did not require specific investigations might be seen as attractive to those wishing to avoid scrutiny. Issues about quantification of creditor claims might be too easily subverted. For example how are contingent claims or tortious claims to be addressed and quantified?

One possible way that the concerns giving rise to this recommendation might equally be met would be by "fixing" the costs of the baseline requirements of any winding up without need for creditor approval while permitting additional remuneration for identified and agreed tasks going forward.

² See for example the ability to make directors liable for entitlements under the Fair Work Act.

³ Query whether the protection under section 443A of the CA will be sufficient protection to suppliers on standing supply contracts entered pre-administration.

- 20 The Committee opposes Recommendation 15.6. The limitation on application of ipso facto clauses is conceded as a means to circumvent diminution of enterprise value through the actions of a party in a reconstruction process. In any large pre-insolvency workout secured creditors will always be a key stakeholder and often are the impetus behind a workout. The limitations on secured creditor rights and the subjecting of secured creditors to unsecured creditor interference may result in a re-pricing of debt and a much costlier enforcement process. There is no warrant for interfering with the contractual rights of parties as suggested particularly where the duties of secured creditors in dealing with secured assets are well settled by the Courts and accepted by stakeholders.
- 21 The Committee supports Recommendation 15.7.
- 22 There are divergent views as to the need for a Director Identity Number the subject of Recommendation 15.8. While this might be seen as a panacea for certain specific abuses and/or illegal conduct it is also seen as subjecting the vast majority of honest and law abiding directors to a further layer of regulation.

5. Contact details

- 23 Questions regarding this Submission can be addressed to the following:

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