ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

2 March 2015

Commissioners
Business Set-up and Closure in Australia
Productivity Commission
GPO Box 1428
CANBERRA ACT 2601

By email: business.inquiry@pc.gov.au

Dear Commissioners

Business Set-up, Transfer and Closure – Issues Paper December 2014

Please find following our submission in relation to this paper.

The role of Australia's insolvency regime should be to provide a structure to enable the restructuring and turnaround of viable business; and provide an efficient and effective process for the redistribution of capital of unviable businesses. While ARITA believes that Australia's insolvency laws have served us well, we have made a number of suggestions for improvement in our Policy Positions Paper at Appendix A.

Need for greater restructuring focus

It is ARITA's strong view that one of the critical issues that needs to be addressed in Australia is a lack of a restructuring culture. Put simply, that means taking much earlier professional guidance before organisations succumb to higher levels of financial distress. We believe that embedding an ongoing process of organisational review and improvement is critical in building sustainable businesses and it would reduce the incidence of technical insolvency and/or the need for distressed asset sales. We also believe that a shift in our insolvency and restructuring regime that would provide for better opportunities for early restructuring would reduce some of the stigma associated with 'admitting' corporate failure. These are not aspects that were raised specifically in your issues paper, and so

while they are covered at least in part in our attached policy papers and briefly in our submission, we don't feel that that we were able to give enough weight to these important issues. We believe that the Commission's report would gain significantly from given additional contemplation to addressing this.

Key points

Following our careful consideration of the matters raised in your issues paper, and subject to the detailed responses in our submission, we highlight the following key points.

- Key Point 1: Insolvency of its nature seeks to balance a wide range of competing interests
- Key Point 2: That the Commission review and consider the 11 policy positions detailed in ARITA's Policy Positions paper
- Key Point 3: We refer the Commission to the many studies that have been undertaken in relation to insolvency in Australia and internationally in like economies
- Key Point 4: An efficient system to manage the insolvency consequences of market saturation ensures good capital allocation
- Key Point 5A: All directors should be issued with a unique 'director identify number' (DIN) and be required to undertake basic governance and conduct training
- Key Point 5B: Prudent lending ensures available capital is efficiently allocated
- Key Point 5C: The choice of business structure can heavily influence how effectively the insolvency process operates and the efficient reallocation of capital
- Key Point 6A: ARITA's Policy Positions paper outlines key reforms that will streamline the operation of Australia's distressed business environment
- Key Point 6B: The choice of business structure and isolating personal wealth can influence the consequences of insolvency on entrepreneurs
- Key Point 6C: Insolvency must find the balance between commercial effectiveness and commercial morality
- Key Point 6D: The insolvency process is much more than simply a transfer between participants in the process
- Key Point 6E: Insolvency is inherently a public process but there is some potential for alternative forms of dispute resolution and appellable administrative decisions
- Key Point 6F: Employee entitlement protection schemes may present a moral hazard that encourage businesses to manipulate their creditor position prior to appointing an external administrator

- Key Point 6G: Government policy and the actions of the ATO affect decisions regarding business closure
- Key Point 7A: Entrepreneurism should not be at the expense of good corporate governance and good lending practices
- Key Point 7B: Australia's insolvency regime needs to encourage earlier intervention for viable businesses in financial distress

Further assistance

ARITA remains available and committed to assist in this reference.

We trust these comments assist. Should you wish to discuss any aspect of our submission, please contact us.

Yours sincerely

John Winter
Chief Executive Officer

About ARITA

The Australian Restructuring Insolvency and Turnaround Association (ARITA) represents practitioners and other associated professionals who specialise in the fields of insolvency, restructuring and turnaround.

We have more than 2,000 members including accountants, lawyers, bankers, credit managers, academics and other professionals with an interest in insolvency and restructuring.

Some 76 percent of registered liquidators and 86 percent of registered trustees are ARITA members.

ARITA's mission is to support insolvency and recovery professionals in their quest to restore the economic value of underperforming businesses and to assist financially challenged individuals.

We deliver this through the provision of innovative training and education, upholding world class ethical and professional standards, partnering with government and promoting the ideals of the profession to the public at large.

The Association promotes best practice and provides a forum for debate on key issues facing the profession. We also engage in thought leadership and advocacy underpinned by our members' knowledge and experience.

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1 Overview

Key Point 1: Insolvency of its nature seeks to balance a wide range of competing interests

We note that the issues paper says [2] that while the interests of business will be a key consideration, the Commission will seek to ensure that its proposed recommendations provide the best outcomes for the wider community.

As a professional body, ARITA also believes that there are additional public interest factors that require consideration beyond purely the interests of business. Accordingly, we seek to emphasise the public interest aspects that are a fundamental part of insolvency law. Insolvency, of its nature seeks, to balance a wide range of competing interests, including not only the creditors, but also the business, its preservation, and its officers or the interests of the individual in personal insolvency; and, critically, the efficient allocation and reallocation of all forms of capital.

The public interest, for example in relation to the prosecution of wrong doing, and the maintenance of the integrity of the regime, is important. Businesses, taking advantage of the protection of corporate veil, should have an obligation to maintain their governance and conduct at a high level, in particular in dealing with the creditors of the business; the law against insolvent trading is one example.

The issues paper says it will also have regard to the Financial System Inquiry ("FSI") Report and its analysis and recommendations to facilitate future innovation in the financial system. In that respect, while the FSI Report said little about the insolvency regime, we do draw attention to some significant insolvency-related issues in the report. These directly or indirectly go to the problem of impediments to business innovation and the lack of a digital identity framework, and a lack of data and data driven business models.

You will be aware that the government has, in October 2014, raised the issue of Australia's approach to business failure in the context of what are said to be impediments to innovative research, reinforced, it is suggested, by strict directors' liabilities and our restrictive insolvency laws.[1] These are raised in the context of looking at ways to promote innovation in research into health, transport and science, but also in business initiatives.

The government paper refers to an OECD report saying that insolvency regimes "can foster experimentation with risky technologies if they do not sanction business failure too severely", and that "insolvency reforms that lower the cost to close a business can promote investment

[1] *Boosting Commercial Returns from Research, Department of Education and Training, which itself refers to a 2013 OECD paper "Raising the Returns to Innovation: Structural Policies for a Knowledge-based Economy", OECD Economics Department Policy Notes, No. 17 May 2013.*

in more innovative business ventures by reducing the expectation of entrepreneurs that they will be heavily penalised in case of failure".

2 ARITA Policy Positions

Key Point 2: That the Commission review and consider the 11 policy positions detailed in ARITA's Policy Positions paper

As you would be aware, ARITA has previously provided you with a copy of its discussion paper, A Platform for Recovery 2014. This discussion paper has recently been finalised into a Policy Positions paper and a copy of the finalised paper is attached at Appendix A for your reference.

The policies in the Policy Positions paper form the key basis of ARITA's submission to the Commission and are as follows:

- Policy 15-01: ARITA Law Reform Objectives (Corporate)
- Policy 15-02: Aims of insolvency law
- Policy 15-03: Current Australian corporate restructuring, insolvency and turnaround regime and the need for change
- Policy 15-04: Creation of a Restructuring Moratorium (Safe Harbour)
- Policy 15-05: Stronger regulation of directors and creation of a director identification number
- Policy 15-06: Advocate for Informal Restructuring
- Policy 15-07: Reworked Schemes/Voluntary Administration regimes to aid in the rehabilitation of large enterprises in financial distress
- Policy 15-08: Extension of moratorium to ipso facto clauses
- Policy 15-09: Streamlined Liquidation for Micro Companies
- Policy 15-10: Micro Restructuring
- Policy 15-11: Pre-positioned sales

Fundamentally, ARITA believes that the existing Australian insolvency and restructuring framework not only serves the Australian financial system and economy well, but that it also stands up strongly in comparison to other regimes across comparable global markets. Nonetheless, we believe that the policies identified above are key areas for improvement of the existing framework to provide the best outcomes for the wider community.

3 The Commission's approach

Key Point 3: We refer the Commission to the many studies that have been undertaken in relation to insolvency in Australia and internationally in like economies

3.1 Question 1 - Recommendations and leading practices relevant to this inquiry

Two publications of the Commission are directly relevant: the Annual Review of Regulatory Burdens on Business of 2010, *4.5, Insolvency Practitioners*; and the research report of 2000, *Business Failure and Change: An Australian Perspective*.

The report of the American Banking Institute into the US Bankruptcy Code, and specifically Chapter 11 of the Code, is also relevant[2]. In particular, it was a major review and assessment of Chapter 11 to which we need to have regard in any consideration of the merits or otherwise of implementing aspects of Chapter 11 in Australia. We note that the FSI Report has recommended that this consideration take place. ARITA has considered the merits of implementing aspects of Chapter 11 in Australia and we refer you to our policy number 15-07 in this regard.

In the UK, a report was recently issued on what are termed pre-packaged insolvencies (or pre-packs), whereby the assets and liabilities of the company are dealt with before the formal appointment of an administrator, in order to avoid the negative impact on the business and its value that insolvency involves. The report – the Graham Review into pre-packaged administration, June 2014 - is by Teresa Graham CBE and it makes recommendations for non-legislative voluntary solutions to be adopted by the profession. At the same time, the UK Small Business, Enterprise and Employment Bill includes a reserve power to prohibit such sales if voluntary progress is not made.[3] This is to address concerns raised, and echoed by ARITA, with the pre-pack sale of businesses to related parties without appropriate independent review. We refer you to Annexure B of our Thought Leadership Paper which explains the process in more detail and expresses our concerns about it; and to our policy number 15-11 outlining ARITA's position regarding pre-appointment sales of assets.

The UK Small Business, Enterprise and Employment Bill also seeks to foster and encourage "the entrepreneurial spirit that thrives in the UK" in recognition of the part that SMEs play in the economy. The Commission may wish to review the Bill but we mention only that it, for

[2] American Bankruptcy Institute Commission to Study the Reform of Chapter 11 of the U.S. Bankruptcy Code: Report and Recommendations 2014

[3] There is significant UK academic, empirical and other research into pre-packs to which we can refer you if needed.

example, seeks to provide SMEs with greater access to finance, and greater ease in establishing businesses. Certain insolvency measures in relation to communication with creditors are also included. The Bill seeks to increase creditor engagement in the insolvency process by encouraging the use of internet based decision-making processes.

There have been numerous inquiries into insolvency law and practice over the years, with some action being taken by way of legislative or other reform. The major 2007 reforms to the Corporations Act, under the Insolvency Law Reform Bill 2007, arose out of reports from the Corporations and Markets Advisory Committee (CAMAC) and other inquiries throughout the previous several years. These reforms, for example, introduced greater disclosure requirements in relation to practitioner remuneration. Since then, the ARITA Code of Professional Practice ("ARITA Code") has sought to give on-going guidance to our members on what was a significant change in insolvency law and practice. More particularly, in 2009, CAMAC released its report "*Claims by shareholders against insolvent companies: implications of the Sons of Gwalia decision"* concerning the legal and practice implications of the High Court decision in *Sons of Gwalia* v *Margaretic* 231 CLR 160. Recommendations from the CAMAC report led to amendments to the Corporations Act that in effect postponed dividend payments of potentially complex and drawn out shareholder/creditor claims. These reforms were said to ensure that administrations involving such claims were not unduly delayed.

The ARITA Code is regarded as setting a high benchmark internationally for standards of conduct by insolvency practitioners. It is often referred to by the Australian Securities and Investments Commission (ASIC), the Australian Financial Security Authority (AFSA) and the Courts as representing best practice for insolvency in Australia. It has also been the subject of favourable attention in the UK, particularly in relation to the key areas of remuneration and independence.

3.2 Question 2 - International research

The issues paper mentions that there are a number of international indexes that rank international performance on various measures of competitiveness, regulation and governance that are likely to impact on business set-up, transfer and closure. These also include the effectiveness of a country's insolvency regime.

The World Bank regularly publishes assessments of the ease of doing business. This includes identification of weaknesses in existing bankruptcy law and the main procedural and administrative bottlenecks in the insolvency process.[4]

The most recent round of data collection for the project was completed in June 2014 and a comparison of the data from like economies is provided below for your reference[5].

[4] http://www.doingbusiness.org/data/exploretopics/resolving-insolvency

World Bank – Assessment of insolvency regimes						
	Resolving Insolvency rank	Resolving Insolvency DTF	Time (years)	Cost (% of estate)	Outcome (0 piecemeal sale and 1 going concern)	Recovery rate (cents on the dollar – secured debt)
Australia	14	81.60	1.0	8.0	1	81.9
Canada	6	89.17	0.8	7.0	1	87.3
New Zealand	28	71.56	1.3	3.5	1	83.6
United Kingdom	13	82.04	1.0	6.0	1	88.6
United States	4	90.12	1.5	8.2	1	80.4

Information on the methodology applied can be found at http://www.doingbusiness.org/methodology/resolving-insolvency

World Bank – Assessment of insolvency regime					
	Commencement of proceedings index (0-3)	Management of debtor's assets index (0-6)	Reorganization proceedings index (0-3)	Creditor participation index (0-4)	Strength of insolvency framework index (0-16)
Australia	2.5	6.0	0.5	3.0	12.0
Canada	3.0	5.5	2.0	3.0	13.5
New Zealand	3.0	3.0	0.5	2.0	8.5
United Kingdom	3.0	5.0	1.0	2.0	11.0
United States	3.0	6.0	3.0	3.0	15.0

Information on the methodology applied can be found at http://www.doingbusiness.org/methodology/resolving-insolvency

We note one approach taken in the UK is that the British Business Bank seeks out funding for small business enterprise start-ups, where funding would otherwise be difficult under

[5] Information on the methodology applied can be found at http://www.doingbusiness.org/methodology/resolving-insolvency

traditional lending arrangements.[6] Other countries, for example Canada, have similar approaches.

One necessary concomitant in any such approach is to have business training and mentoring. While ARITA does not go into detail about such approaches in this submission, we do consider that directors of companies should receive some minimum level of education in relation to their responsibilities. We made recommendations to CAMAC some time ago about this and have raised it in our Policy Positions paper (policy 15-05) and other submissions.

[6] See http://british-business-bank.co.uk/what-the-british-business-bank-does/ ; and https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/324051/British-business-bank-stragic-plan.pdf

4 Trends in business set-up, transfer and closure

Key Point 4: An efficient system to manage the insolvency consequences of market saturation ensures good capital allocation

4.1 Question 3 – Proportion of new business displaying entrepreneurial or innovative characteristics

ARITA does not have relevant or sufficient knowledge in this area and is unable to comment on the matters raised in the issues paper.

4.2 Question 4 - Optimal level of business set-ups

In our view, over-creation may in fact lead to business failure because of saturation of the market and that is for the market to determine. In the event of market failure, an efficient system to manage the insolvency consequences of market saturation ensures good capital allocation.

5 Barriers to business set-up

Key Point 5A: All directors should be issued with a unique 'director identify number' (DIN) and be required to undertake basic governance and conduct training

Key Point 5B: Prudent lending ensures available capital is efficiently allocated

Key Point 5C: The choice of business structure can heavily influence how effectively the insolvency process operates and the efficient reallocation of capital

5.1 Questions 5 to 10 Regulation to establish a new business

Although the issues paper speaks of regulatory requirements that act as a disincentive to set-up or acquisition, we believe that consideration should be given to the implementation of a unique 'director identity number' (DIN) in order to more readily identify and monitor a director's involvement in companies.

Presently there is no requirement to provide proof of identity when registering or updating director appointments in the corporate register maintained by ASIC. Safeguards, such as proof of identity requirements, could be put in place at the time of obtaining a DIN to mitigate the chance of inconsistent, misleading or false information being included on the corporate register. This would ensure that directors of companies who approach an insolvency practitioner in order to have their company enter external administration, can be clearly identified; and would assist in investigations of a director's involvement in what may be repeated unlawful phoenix activity. From the business and general community's perspective, it provides transparency and hence trust in relation to the background of companies with which the community deals.

As one recent example of the abuse that can currently be undertaken, ASIC has recently successfully taken action against an accountant providing pre-insolvency advice who was found to be complicit in the appointment of fictitious directors to a company prior to its liquidation[7].

As mentioned earlier, businesses taking advantage of the protection of corporate veil should have their governance and conduct maintained at a high level and directors need to undertake basic training on these responsibilities.

We are obviously more familiar with the requirements regarding business exits rather than the establishment of new businesses, but note that our insolvency regime pays little regard to the differences between large and small enterprises, and their respective directors and

[7] ASIC media release 15-031MR Gold Coast chartered accountant sentenced following ASIC investigation

the directors' motivations. That difference is particularly relevant when considering the duties of directors.

Large companies most often have professional directors with little personal involvement in the fate of the company, beyond their duties to it as directors. They may tend to be risk averse in what is often referred to as the "insolvency twilight zone" [8] in order to preserve their professional reputation and minimise their personal liability. They may be more readily prompted to invoke a formal insolvency appointment in order to avoid any risk of liability for insolvent trading.

In contrast, small companies most often have directors who are also owners and guarantors of the company's liabilities, and they do not necessarily have the same 'professional' reputation to preserve. Theirs is more a business and commercial focus. Accordingly, in the 'insolvency twilight zone', they have everything on the line and tend to be comparably large risk takers. The threat of personal liability for insolvent trading and of breach of directors' duties is perceived to be far less.

5.2 Questions 11 to 12 – Access to markets

ARITA does not have expertise in this area and is unable to comment on the matters raised in the issues paper.

5.3 Question 13 – Reducing regulatory barriers

ARITA's Policy Positions paper details a number of reforms to Australia's insolvency framework aimed at improving the high level operation and function of the market.

On a more practical level, ARITA made a submission to the FSI[9] noting the need for insolvency law and practice to embrace technology and take advantage of its costs savings. This is so in particular because the economics of insolvency are such that the costs in the process are a necessary levy on the capital that may ultimately be returned to the system via the returns that are repaid to creditors.

At the request of the FSI, a further submission was made detailing more information and examples where ARITA considers technology can assist[10].

5.4 Question 14 – 16 – Access to finance

[8] See INSOL International, Directors in the Twilight Zone.

[9] Submission of 26 August 2014 which is available on the ARITA website http://www.arita.com.au/docs/default-source/submissions/arita-submission-to-the-financial-system-inquiry-.pdf?sfvrsn=2

[10] ARITA's further submission to the FSI is available on the ARITA website http://www.arita.com.au/docs/default-source/submissions/arita-to-fsi-on-technology.pdf

One fundamental development in Australia in support of both access to finance and of the insolvency regime itself is the Personal Property Securities Act 2009 which has aimed to provide certainty to those borrowing and lending in Australia. It allows secured lenders, including creditors seeking to protect their on-going extensions of credit, in doing business. Its international significance, alongside comparable laws in New Zealand, Canada and elsewhere, is emphasised in terms of the attraction of business funding. The Commission will be aware that a major review of the PPS regime, to which ARITA made submissions, is being tabled by the government on 18 March 2015. Some of our recommendations to the review went to the issue of streamlining various PPS insolvency-related processes.

ARITA does not have expertise in the detailed area of access to finance for business set-ups, however we highlight that cash flow of a business is vital to its solvency, in particular in its set up phase.

The vast majority of insolvency appointments, particularly in the SME sector, involve companies with poor, or no, books and records. A failure to maintain adequate books and records is an indicator of poor governance and would often hurt the ability of companies to borrow as it would be considered a poor lending risk. ARITA queries whether it is reasonable that companies that fail these basic governance requirements should be entitled to finance.

A basic concept in the provision of finance is the right to ensure the funds you lend are repaid in accordance with terms agreed at the time of entering into the finance agreement. Typically, but not always, significant finance is only provided on the basis that the lender obtains security to mitigate their risk. The underpinning of lending activity with a realisable and recoverable asset-backing is also important from a banking perspective in so far as it is a determinant as to what type of lending that banks can maintain within their lending portfolio and still meet their capital adequacy requirements. The various Basel agreements and APRA's work to ensure that the operations of major banking institutions are able to be sustained without themselves entering into financial distress, are important considerations.

In Australia, the rights of secured lenders are protected and the *Corporations Act* and contract law provides this protection. In addition to the contractual right to appoint an insolvency practitioner (generally a receiver or receiver and manager), security documentation also generally provides a secured lender with the right to undertake a review of the company in certain circumstances, referred to as an Investigative Accountant (IA) or Independent Business Review (IBR).

We note that in the US and UK lenders have less protection. The right of a secured creditor to appoint a receiver has been removed in the UK, under its *Enterprise Act 2003; see Insolvency Act 1986, Chapter IV, and Prohibition of Appointment of Administrative Receiver*. An administrator appointed acts both for the secured creditor and the unsecured creditors, with the secured creditor being one of the parties able to appoint the administrator. As such, the secured creditor's recourse is the appointment of an administrator rather than the appointment of a receiver. In Australia, secured creditors maintain their right to appoint a receiver, but are also one of the parties that have the power to appoint a voluntary administrator.

It is important to note that in markets where the traditional enforcement rights of secured lenders have been removed, new mechanisms have evolved to provide that secured lending status. For example, we understand that in the UK, secured creditors are the significant beneficiaries of the pre-pack regime that has developed there, with unsecured creditors rarely receiving any distribution[11].

It should be said that, appropriately and prudently, there is no obligation on a lender to lend. Indeed, good and sustainable lenders are generally those who apply rigid lending criteria and appropriate risk pricing to their lending activities. By ensuring good lending, lenders safeguard the potential availability of funding to good business opportunities. Losses in lending naturally diminish the available pool.

The US and Canadian insolvency laws, which allow for the debtor to 'remain in possession' of their insolvent company, specifically provide for debtor-in-possession finance to be made available during that external administration phase.

By comparison, Australia's law provides limited statutory provisions allowing for such financing during an insolvency process aimed at restructuring the business (for example, in a Voluntary Administration to allow trading to continue). ARITA accepts that the courts have the power to allow, and have allowed, third party financing in voluntary administration/deed of company arrangements and schemes of arrangement, however we believe there should be a recognised process for prioritising funding to better facilitate restructures via an external administration.

5.5 Questions 17 to 20 – Improving access to finance

While ARITA does not have specific expertise in this area and we will necessarily limit our comments not much beyond referring to our comments at 5.4 regarding access to funding in external administrations, we do believe it is important to note that our members continue to see the widespread take up of new forms of business funding, including in the secondary market.

While not yet prevalent, P2P funding including the likes of Kickstarter, is beginning to influence the market. Much of that funding is non-recourse.

The rise of private equity, venture capital and other non-bank lending continues strongly. This is augmented by the arrival of the secondary debt market where organisations will take on distressed lending from other more traditional lenders and take a work-out approach to the debtor.

[11] 'Pre-Pack Empirical Research: Characteristic and Outcome Analysis of Pre-Pack Administration - Final Report to the Graham Review April 2014' prepared by Professor Peter Walton and Chris Umfreville of University of Wolverhampton, UK.

It must be said that any decision to "improve" access to finance should not be at the expense of good lending practice. From our members' experience, a key contributor to the extent of the GFC was poor lending practices where inadequate credit assessment and limited recourse lending become more prevalent. This was coupled with an excess amount of capital being available for lending – a flooding of the market leading to the forgoing of risk pricing in order to "sell" loans. Where situations arise that lending with poor controls and poor credit worthiness assessment becomes prevalent, we invariably see a rise in insolvency and the associated loss of productive capital.

There appears to be little evidence, from our end of the market and our dealings with lenders of all types, that there is any scarcity of finance in the market. Indeed, we found the colourful recent comments from co-founder of pioneering start-up, Atlassian, Mike Cannon-Brookes, to be instructive when *The Australian* reported:

> "Mr Cannon-Brookes said that while Australia was often criticised for a lack of access to capital for start-ups, causing many businesses to relocate to the US, he did not believe that was true. "Capital is not the problem," he said. "Some people can't get that capital, but I think maybe it's because they're running sh**ty businesses." [12]

5.6 Questions 21 to 22 – Access to payments systems

ARITA does not have expertise in this area and is unable to comment on the matters raised in the issues paper.

5.7 Questions 23 to 24 – Foreign investment and the tax system

ARITA does not have expertise in this area and is unable to comment on the matters raised in the issues paper other than to note that ARITA believes that many businesses are set up in structures for two reasons, to:

- secure tax advantages for the business and its owners; and
- ensure separation of risk and liability in the event of business failure.

Yet the structure, or separation of the business, is not necessarily required for the effective and efficient governance and operation of the business. The advantages of the particular chose structure are exploited, while the obligations are ignored.

[12] The Australian – February 23, 2015 - http://www.theaustralian.com.au/business/atlassian-float-just-a-speed-bump-says-co-founder/story-e6frg8zx-1227234580662

We believe that tax laws tend to distort business structures, examples of this is a managed investment scheme at the complicated end of the spectrum or a unit trust through which a small business operates at the simpler end.

Particularly in SMEs, there is also a lack of understanding as to what the obligations of the company/trust, directors and/or trustees are under the structure that is established. This extends to governance, financial record keeping and taxation obligations. Furthermore, our members regularly see the inadequate separation of personal and corporate finances in SMEs, with personal expenses often claimed as business expenses. Again, this supports our recommendation for basic education requirements for directors.

5.8 Questions 25 to 27 – Other barriers

While it is not an issue on which you ask directly, we point out that Australia's laws do not provide an adequate regime for the winding up of insolvent trading trusts. We refer the Commission to recent commentary[13] by D'Angelo which explains the need to assess any given body of organisational law "by reference to whether it facilitates or hinders efficiency between and among participants in, and those dealing with, an entity". The author gives obvious examples of 'efficient' rules under the *Corporations Act*, but "(i)n stark contrast, Australian trust law has no equivalents to any of these and can be argued to be inefficient economic effect on the conduct of business via the trust vehicle, making the process of transacting by and with a trustee riskier or more expensive or both. … Errors and residual uncertainties invite litigation when disputes arise or insolvency intervenes".

The author notes that the NZ Law Commission is reviewing the *NZ Trustee Act 1956* and trust law generally. In the first stage of this review, the Commission has issued a Report - *Review of the Law of Trusts: a Trusts Act for New Zealand (R130)* – which makes recommendations for the introduction of a modern and comprehensive new trusts law, including as to insolvency of trading trusts.

D'Angelo summarises some of the issues that arise when a trust is affected by insolvency, that a corporatised trust cannot be put into voluntary administration or liquidation; unsecured trust creditors, who can only get at trust assets in insolvency via subrogation to the trustee's indemnity, are at risk of losing this access if the trustee has misconducted itself; the complexities in relation to the laws relating to voidable transactions undertaken by corporatised trusts in their trustee capacity and other such issues.[14]

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[13] *The trust as a surrogate company: The challenge of insolvency*, by Dr Nuncio D'Angelo, (2014) 8 J Eq 299.

[14] He goes on to list that there no clear rule as to when an insolvent corporate trustee should be removed and replaced as trustee; there is confusion as to the powers of a trustee's liquidator if a trust instrument has a clause automatically removing the trustee from its office upon insolvency; there is a lack of clarity as to if and when an administrator or liquidator may take remuneration out of trust assets where the company is a trustee; and there can be uncertainty in how these issues are dealt with in situations where the same company is trustee of multiple trusts or schemes, all of which are affected by financial distress.

The lack of a comprehensive regime for dealing with insolvent trusts, including managed investments schemes, is a major exit impediment.

The issues and difficulties around the insolvency of Managed Investment Schemes have been considered by CAMAC in report of July 2012, *Managed Investment Schemes*, which made numerous recommendations.[15] CAMAC subsequently issued a further discussion paper on important related issues in June 2014.

ARITA made submissions in respect of these inquiries by CAMAC.[16] On the disbandment of CAMAC in 2014, responsibility for the second discussion paper was assumed by Treasury and there has been no report issued to date.

[15] http://www.camac.gov.au/camac/camac.nsf/byheadline/pdffinal+reports+2012/$file/mis_report_july2012.pdf

[16] October 2011 - http://www.arita.com.au/docs/default-source/submissions/ipa-final-signed-submission---camac-mis.pdf?sfvrsn=0; June 2014 - http://www.arita.com.au/news-preview/2014/06/10/submission-to-treasury-on-camac-mis-discussion-paper

6 Barriers to business transfer and closure

Key Point 6A: ARITA's Policy Positions paper outlines key reforms that will streamline the operation of Australia's distressed business environment

Key Point 6B: The choice of business structure and isolating personal wealth can influence the consequences of insolvency on entrepreneurs

Key Point 6C: Insolvency must find the balance between commercial effectiveness and commercial morality

Key Point 6D: The insolvency process is much more than simply a transfer between participants in the process

Key Point 6E: Insolvency is inherently a public process but there is some potential for alternative forms of dispute resolution and appellable administrative decisions

Key Point 6F: Employee entitlement protection schemes may present a moral hazard that encourage businesses to manipulate their creditor position prior to appointing an external administrator

Key Point 6G: Government policy and the actions of the ATO affect decisions regarding business closure

We have responded to Section Four of the issues paper by considering the matters raised by groups of questions and then answering a selection of questions more specifically.

6.1 Questions 28 to 33 – Improving insolvency arrangements

As mentioned in Section 2, ARITA's Policy Positions paper forms the key basis of ARITA's submission to the Commission and is particularly relevant to the matters raised in this section of the issues paper. We refer you to the Policy Positions paper at Appendix A for our response to this section, specifically noting that it provides for feasible alternatives to the existing corporate insolvency arrangements and fully supports and advocates for the implementation of a restructuring moratorium (safe harbour) provision.

Choice of business structure

There is little doubt that potential insolvency shapes the choice of business structure in many start-ups. This is particularly so within more speculative industries such as property development or in the case of trusts that are defined for their asset distancing properties. Given the wide awareness of the frequency of start-up failure, it is entirely unsurprising that consideration of what happens in the case of failure is a key consideration for those going

into a new business. In small business start-ups, where entrepreneurs often put their entire assets into the start-up, the awareness of what is at risk is a primal one.

Of course, the very historical nature of a *Proprietary Limited* structure was to define a limitation as to the recourse against directors, and this is where ARITA refers to the benefits of corporate structures and a necessary burden on directors for the enjoyment of those structures.

We would contend that an informed person would know that in setting up a company, they must abide by their duties as directors; that there is a duty to prevent insolvent trading; and that tax liabilities impose particular obligations and potential personal liability. These three examples are often activated when a company fails. However, ARITA believes that none is of such a burden as to be a disincentive to the corporate structure, given the wide protection provided by limited liability.

In the case of less reputable directors, the perception of the ease of exit from the corporate structure by way of unlawful phoenixing may be an incentive to (mis)use the corporate form, either in contemplation of likely failure, or deliberate failure. This is well described in a recent paper, '*Defining and profiling phoenix activity*'[17], as the "illegal phoenix type 2 – phoenix as a business model" –"the company is deliberately set up to be phoenixed; that is, its controllers never intend the company to succeed".

It's also fair to note that lenders and even creditors with whom the business will trade, are well aware of the protection or otherwise of the various corporate structures and will often seek personal guarantees or other personal securities to obviate protection from their claims.

We do believe, though, that in most instances tax effectiveness is stronger influence on the type of business structure selected than a preparation for insolvency.

Sanctions in personal insolvency

The word sanction in bankruptcy law refers to certain penalties or restrictions imposed on a bankrupt who has engaged in some misconduct. We understand the issues paper to use this word as the imposition of restrictions of bankruptcy law on all bankrupts and we proceed on that understanding.

The question asked is broad but essentially bankruptcy is accepted to provide a number of purposes, to relieve the debtor of their debts, to require the bankrupt to give up their assets, and to protect creditors and the community. The imposition of restrictions in bankruptcy, for the three year period it operates (subject to possible extension of up to eight years), serves that latter purpose. The person who is bankrupt cannot incur credit without disclosure, any

[17] Melbourne Law School, Monash Business School, Research Report 2014

assets they acquire pass to the trustee, they cannot be a company director, and cease to be one on their bankruptcy, and external bodies often impose limitations on a person who is bankrupt.[18]

Therefore, during bankruptcy, there is a restriction on a person returning to full commercial and consumer life. The issues paper queries whether the three year, or more, period is economically disadvantageous. A person who has been in business but whose business has failed resulting in the person's bankruptcy will be largely prevented from or limited in, resuming business activities for the three year period.

In the UK, the period of bankruptcy is now one year, reduced from three, as we understand, in order to promote the benefits of resumption of business activity.[19] Even in the case of consumer bankrupts, there is economic commentary that their release to further consume is beneficial.[20]

Of course balanced against these economic objectives is the need to maintain some legal concern about the fact that creditors are invariably left unpaid and this can have a negative impact on their solvency, particularly in business. Insolvency generally involves a balance between these two issues. Public perception of the relief from debt that bankruptcy provides is also important for the integrity of the regime and in general.

It may be argued that the three year period may too much delay the re-entry of a person into business. There is also the broader consequence, that the contemplation of a three year period of bankruptcy, and the opprobrium that this involves, may be some disincentive.

As to the normal sanctions of bankruptcy, we do not think these should be disturbed. All assets vest but there are appropriate exemptions. Income contributions must be made but only above a certain income level. The need to account to and cooperate with the trustee is fundamental. We would not contemplate any domestic home exemption, nor substantial business assets, as being exempted.

There are external restrictions; principally that the bankrupt cannot be a director. This a rather blunt restriction in that the reasons for the bankruptcy may involve no misconduct or mismanagement of the bankrupt at all, yet it applies generally.

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[18] A convenient schedule of these limitations is found at www.afsa.gov.au

[19] Academic research on the entrepreneurial restrictions of bankruptcy is usefully contained in *Bankruptcy and Entrepreneurship*, by John Armour and Douglas Cumming, American Law and Economics Review, Vol. 10, Issue 2, pp. 303-350, 2008.

[20] See *House of Debt*, which emphasises the importance of debt relief for *consumer* debtors in contributing to economic growth: http://houseofdebt.org/. In relation to recent Irish law, about which the Commission inquired of us, see *Long Overdue: What The Belated Reform of Irish Personal Insolvency Law Tells Us About Comparative Consumer Bankruptcy*, American Bankruptcy Law Journal, 86 Am. Bankr. L.J. 243, by Dr Jospeh Spooner, and to Dr Spooner's other writings on relevant issues.

It is ARITA's opinion that the existing sanctions are adequately enforced, in so far as the law imposes restrictions, the trustee will seek to enforce then, and AFSA undertakes such a role. Prosecutions in this regard are not uncommon.

These sanctions may drive the use of limited liability company structures to protect from personal bankruptcy as a result of business debt, as distinct from consumer debt driven bankruptcies.

Alternatives to the current bankruptcy process

The Australian personal insolvency regime provides a number of alternatives for individuals in financial distress. In addition to bankruptcy (which can lead to an annulment of the bankruptcy through a 'section 73 composition'), financially distressed individuals can also deal with their debts by way of a debt agreement (Part IX of the *Bankruptcy Act*) or a personal insolvency agreement (Part X of the *Bankruptcy Act*).

ARITA believes that the current personal insolvency regime is generally adequate in its policy approach and no alternatives need to be considered, however we readily acknowledge that the consequences of financial failure are clearly harsher in bankruptcy (automatic three year term with restrictions on business activity) without any similar sanctions imposed on directors of corporate insolvencies, unless misconduct has been substantiated.

There has been on-going debate as to whether a bankruptcy trustee should have the power to pierce trust structures to access assets owned in reality, if not in law, by the bankrupt. There have been no recent reforms supporting that power, which in fact raises a larger issue about the use of trusts generally. We reported on our website a judge's comment that it is seen "as inappropriate per se for legal professionals to employ [trust] structures either for the purpose of tax planning, estate planning or even "ring fencing" presently held assets in the event of a successful claim made" in the future; the judge then saying that "if that string were pulled, some very large threads of the legal profession would unravel", and no doubt in other professions and businesses.[21]

It is well recognised within the profession that informed individuals take steps to separate their assets, either through corporate, trust or other structures, to ensure their ongoing financial security in the event of the failure of their businesses, whether those businesses are operated by the individual or through a corporate structure. Notwithstanding the corporate veil, in the SME sector, the typical requirement for personal guarantees to be provided in order to obtain credit, means that a director's personal financial position is directly linked to the financial success or otherwise of the business operated via a corporate

[21] *Not inappropriate for lawyers to engage in asset protection* .... by Michael Murray | Jun 22, 2014 www.arita.com.au

structure. The question is, whether it is appropriate for an individual to be able to organise their affairs in such a way as to protect their personal wealth (for example via a trust) to the detriment of those creditors that provided the funding (via supply of goods and services) to enable their entrepreneurial activities. The law currently recognises that it is not appropriate in circumstances where the individual is already insolvent, however, there are no limits on being able to deal with your assets (that is, restructure your affairs to quarantine your wealth) when you are solvent – notwithstanding that insolvency may occur at some time in the future.[22]

Transfer assets and capital

Due to limited research and a lack of data we are unable to provide specific information regarding the cost, effectiveness and length of insolvency arrangements, although we note that the Productivity Commission Research Report August 2010, *4.5 Insolvency practitioners* provides some useful data, noting that it is now somewhat outdated.

ARITA is aware of anecdotal evidence regarding inefficiencies in the operation of the insolvency arrangements. Notwithstanding, we believe that at its core Australia's insolvency regime is effective and has served our economy well. However, the pending *Insolvency Law Reform Bill 2014* seeks to streamline some of the inefficiencies largely associated with operating two different insolvency regimes and our Policies Position paper puts forward a range of reform ideas that will build upon the current successful foundations.

The World Bank study (mentioned at 3.2 above) indicates that the time for secured creditors to recover all or some of the money owed in Australian insolvencies is comparable to, if not faster than, other similar economies.

Commercial effectiveness isn't sole measure of the value of an insolvency regime: it must also balance the need for commercial morality of those that operate within it and provide a system for the investigation of, and accountability for, financial failure. The policy decision is, where on the spectrum Australia should sit.

For example, some may argue that the UK style pre-pack arrangements provide for a cost effective and quick process for the sale of a distressed company's assets. However, we highlight that the majority of such arrangements in the UK involve sales to related parties, not subject independent review, which may not necessarily result in the transfer of capital to those who are rightly entitled to it. As such, we argue that notwithstanding its perceived effectiveness, it is not the right system for Australia and there are better ways to improve the redistribution of capital of failed businesses that maintains the appropriate balance of commercial morality.

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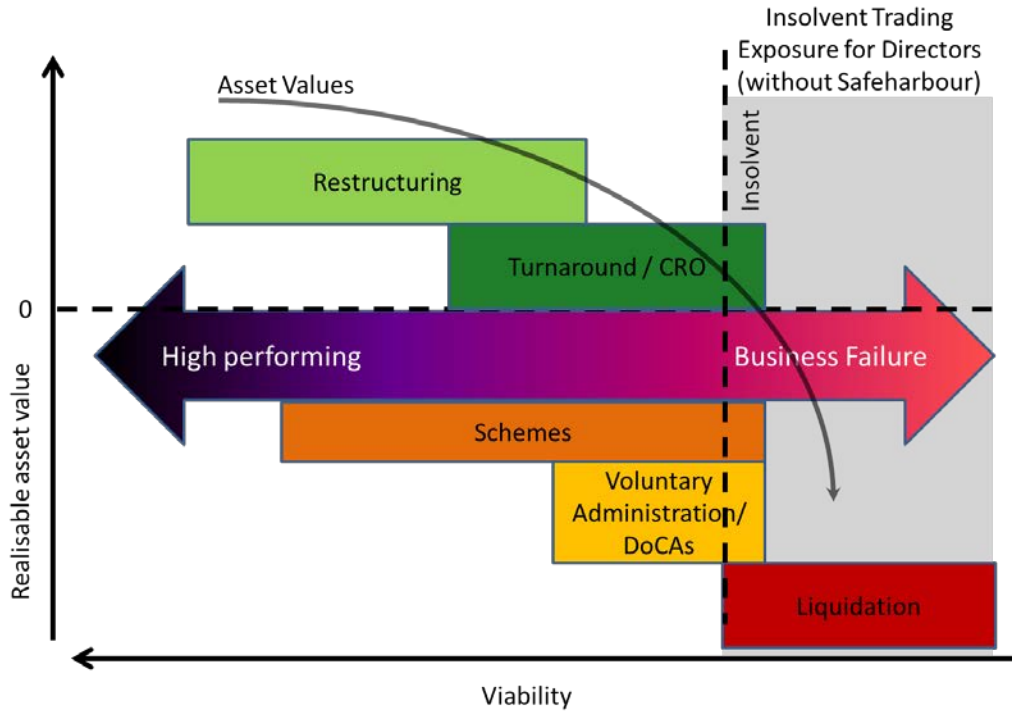
[22] See generally *Risky Business, what happens to personal assets when business fails,* Peter Agardy, Federation Press, 2012.

6.1.1 Question 31 - Are insolvency procedures timely to ensure assets do not become 'stranded' and unable to be used elsewhere?

Assets don't become stranded by insolvency procedures but delays in addressing financial difficulty and delays in the process, may diminish their value. The below diagram from ARITA's Policies Position paper depicts the decrease in value over the continuum of a company's financial distress.



ARITA policy reforms

A number of the reforms detailed in our Policies Position paper are aimed at preserving and/or maximizing value and releasing assets in a more efficient manner than is currently available under the existing regimes.

For example, extending the moratorium in voluntary administrations to those clauses that allow for the termination of contracts simply because of the insolvency event ("ipso facto" clauses), would improve the effectiveness of the voluntary administration regime.

We acknowledge that the streamlined processes we have suggested for micro businesses, will, by their nature reduce the investigation and the review of the reasons for the business' failure, director conduct etc. However, at that end of the market where ARITA proposes that streamlined liquidation would be most appropriate, the advantage of being able to efficiently

and effectively deal with small levels of capital and debts may well be of sufficient enough to outweigh the cost associated with reduced investigation. ASIC reports annually on the outcome of the enforcement action arising from reports lodged by external administrators[23]. The below table from the ASIC 2013-2014 Annual Report provides an overview of the statutory reports received and actioned by ASIC.

Statutory reports – by type and outcome

	2013–14	2012–13
Initial reports from liquidators, administrators and receivers		
Reports alleging misconduct	7,509	6,985
Reports not alleging misconduct	2,295	2,467
Initial reports – outcomes		
Supplementary reports requested	11%	10%
Analysed and assessed for no further action	89%	90%
Total	100%	100%
Supplementary reports requested and received by ASIC		
Supplementary reports alleging misconduct	718	792
Supplementary reports – outcomes		
Referred for compliance, investigation or surveillance	19%	25%
Analysed and assessed for no further action	81%	74%
Identified no offences	<0.5%	1%
Total	100%	100%
Total statutory reports received (initial + supplementary)	10,522	10,244

Source: ASIC Annual Report 2013–2014 page 64

This report would indicate that only 136 of the initial 7,509 reports alleging misconduct were referred for further action. This indicates that there is little likelihood of enforcement action being taken by ASIC as a result of the investigation and reporting work done by insolvency practitioners. As such, it is argued that little will be lost by removing that obligation.

Another streamlined option is the ability to sell assets via a pre-positioned arrangement prior to the appointment of an external administrator. However, we believe that it is imperative that any sale be subject to review by an independent practitioner who has not been involved in the sale negotiations. This differentiates ARITA's proposal from the current UK pre-pack process.

[23] ASIC Report 412 Insolvency statistics: External administrators' reports (July 2013 to June 2014) September 2014 and ASIC Annual Report 2013–2014

We do highlight that the ability to realise assets in a timely manner may be complicated by the corporate structure itself. For example, the winding up of Managed Investment Schemes is a highly complex administration which often requires guidance from the Courts.

We are also of the view that the actions taken by directors in the lead up to the failure of their businesses can contribute to delays in the insolvency process. For example, by transferring assets away from creditors and destroying books and records, or simply not maintaining books and records in the first place; any liquidation will take much longer as it is more difficult to undertake investigations and recovery actions may be taken. Whilst we do not say that this is behaviour that occurs in all business failures, it is our view that it happens too often, particularly the failure to maintain books and records.

6.1.2 Question 32 - Is the insolvency process unnecessarily costly and lengthy? How might this additional cost be measured? Is it simply a transfer between participants in the process or does it represent a loss in the overall efficiency of the economy?

We refer you to our Policies Positions paper which highlights areas for reform that will remove unnecessary cost and time in insolvency processes.

It is highlighted that some of the cost and length of insolvency processes in Australia is associated with the investigation and reporting of the pre-appointment activities and conduct of the company and its officers.

Such investigation may not necessarily lead to asset recovery for creditors and may not be seen to adding value to the process, despite the community value it adds to the integrity of our economy. We note that where funds are recovered in insolvency administration, these funds may be utilised for investigations at the expense of creditors' claims, so in effect creditors are funding the investigations.

It should be noted that in many, or even most, SME liquidations, the company has little or no assets remaining[24], and those assets often prove to be insufficient to meet the liquidator's costs in full.

A study of court ordered liquidations under ARITA's 2012 Terry Taylor Scholarship[25] showed that, in the conduct of official liquidations, official liquidators annually:

- incur $1.9 million in disbursements;

[24] According to ASIC's Report 371 Insolvency Statistics: External Administrators' Reports for the period July 2012 to June 2013, 61.1% of external administrations have $10,000 or less in assets, with 40.1% having less than $1.

[25] The Terry Taylor Scholarship is a research project funded annually by ARITA. The 2012 report was prepared by Amanda Phillips and is available at http://www.arita.com.au/docs/events-documents/2012-tts-report---final-version-%282%29.pdf?sfvrsn=0

- recover $0.5 million of disbursements from asset realisations;
- fund $1.4 million of disbursements from their own resources;
- incur $55.6 million in remuneration; and
- recover $8.3 million in remuneration from asset realisations.

The study concluded that official liquidators, on average, annually fund $47.3 million in unpaid remuneration from their own resources.

Under current ASIC requirements, an official liquidator is obliged to conduct a liquidation to which they are appointed by the court even though no funds are available for their remuneration. This is largely a product of Australia having no government liquidator. We do note that ASIC operates an Assetless Administration Fund from which practitioners may apply to obtain funding to prepare investigative reports to assist ASIC prosecutions, though our members report that funding may be difficult to obtain and doesn't fully remunerate for the work involved.

It is clear that the insolvency process is much more than simply a transfer between participants in the process. There are necessarily costs and time involved, and regulatory requirements that would reduce the value further.

When considering the cost of a formal insolvency administration, it must be noted that the nature of insolvency is such that it can be an expensive exercise for a number of reasons – an experienced and qualified insolvency practitioner is required, who, most significantly, bears personal liability for debts incurred during the period of their appointment; their tasks are extensive in investigating and trying to find a solution; they have statutory reporting obligations to the creditors and ASIC; court assistance can be required; the affairs of the company are invariably in some disarray and its structure and business operations can be complex; the directors may or may not be co-operative; and the creditors' claims can be numerous and in dispute.

In addition to a primary duty to recover assets and pay dividends to creditors, liquidators are required to investigate the conduct of parties leading up to the liquidation, and report offences and other misconduct to ASIC, and assist in the pursuit of such misconduct. That is why ASIC itself refers to liquidators as the "front line investigators of insolvent corporations".[26] Payment of the liquidator for that work in itself consumes funds in the administration, often thereby reducing funds, if there are any, available to pay a dividend. These public interest and fiduciary responsibilities of liquidators are significant

[26] ASIC's Regulatory Guide 16 External administrators - Reporting and lodging

Stakeholders in the insolvency process pay for this for accountability. Creditors are paying for a system that protects them, particularly small creditors who wouldn't have any market power to influence or act otherwise.

We believe that the comments below from local and international insolvency experts clearly articulate a key consideration about the cost of insolvency

"The notion that money paid to professionals belongs to creditors is true only if the creditors could realize that value without the profession" Professor Stephen Lubben [27]

"The task of insolvency administration is inherently expensive. Principally this is so because of the intensive nature of the investigation of accounts (sometimes in a shambles and sometimes deliberately deceptive), that the insolvency practitioners must analyse and understand. This is also true of legal costs. All my life, I have seen litigants asserting the justice of their claim, but unwilling to appreciate that securing an outcome is inherently costly. It is unreasonable to demand that skilled professionals should perform their functions at low cost. Dispute resolution has a cost component" Michael Kirby[28]

6.1.3 Question 33 Part 1 - Are there legal impediments to reforms in this area, such as relying on alternative forms of dispute resolution (appellable administrative decisions, tribunals or alternative dispute resolution based solutions) for simple or uncontested matters?

Insolvency is inherently a public process but there is some potential for alternative forms of dispute resolution and appellable administrative decisions.

The volatile and uncertain nature of insolvency often means that guidance from the Court is often sought during the external administration process. ARITA believes that there is also potential for procedural issues that arise during the administration (eg extension of timeframe to convene meetings, validity of proofs of debt, compromise of claims) to be dealt with via an administrative decisions tribunal. We believe that matters requiring interpretation of the operation of insolvency law would still need to be subject to judicial consideration.

ARITA has plans to implement a tribunal to oversee our conduct framework and provide alternative dispute resolution services, although this service will be aimed at resolving complaints or disputes between stakeholders and our members.

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[27] American Bankruptcy Institute Commission to Study the Reform of Chapter 11 of the U.S. Bankruptcy Code: Report and Recommendations 2014 footnote 211

[28] *Bankruptcy and Insolvency, Change, policy and the vital role of integrity and probity*, (2010) 22(2) A Insol J 4, Michael Kirby.

6.1.4 Question 33 Part 2 - Are there any barriers to innovation by insolvency practitioners?

Australian insolvency laws and regulations are quite restrictive and are designed to protect stakeholders.

Notwithstanding, there are flexible mechanisms available which have evolved to offer innovative options for stakeholders. This includes the development of creditors' trusts through Deeds of Company Arrangements. We do highlight that innovation does not necessarily result in better outcomes for stakeholders and can be used as an abuse of the intent of the law. In this regard we note that creditors' trusts are now subject to specific guidance from ASIC (Regulatory Guide 82) to ensure that the mechanism is not abused.

A further issue that our members are encountering is the rise of inappropriate pre-insolvency advisers who offer advice to financially distressed business and individuals about how to avoid legal and financial obligations. This market is unregulated with unregistered advisers that are not required to have any formal qualifications and are often found preying on the vulnerable. ARITA, of course, firmly supports the need for restructuring professionals that can assist organisations with restructuring and turning around their businesses. We also recognise that those advisors may not be necessarily be registered insolvency practitioners. Indeed, ARITA is expanding our membership categories to provide for highly qualified, professional non-insolvency restructuring practitioners who would be subject to our Code of Professional Practice. However, these unregulated pre-insolvency advisers seem to be growing at an alarming pace.

At a more practical level, legislation can be overly prescriptive and place specific limitations around things like use of technology (communications, online banking etc) and general business management (legislative requirement to obtain receipts, use of cheques, etc).

For further discussion on this issue, we refer you to ARITA's supplementary submission to the Financial Systems Inquiry[29].

6.2 Employee entitlements

6.2.1 Question 34 – How have these employee safety net schemes impacted on business closure? How have these schemes operated alongside the insolvency arrangements? Do these schemes present a moral hazard problem?

Once a company has entered external administration the existence of the scheme may provide an incentive for employees to push for the appointment of a liquidator and

[29] ARITA's further submission to the FSI is available on the ARITA website http://www.arita.com.au/docs/default-source/submissions/arita-to-fsi-on-technology.pdf

crystallisation of their entitlements as the safety net is not available where a company enters a Deed of Company Arrangement. This may encourage a bias towards shutting a business down and employees receiving lump entitlements in the short term versus ongoing employment with a less certain future.

We do believe that these schemes may present a moral hazard, with businesses manipulating their creditor position prior to the appointment of an external administrator in the knowledge at that FEG will cover employee entitlements.

A recent example that raised concern about the misuse of FEG was Bruck Textiles[30]. Media reports indicate that Bruck went into liquidation in July 2014, resuming the next day as Australian Textile Mills, in the process leaving some 60 staff relying on FEG for $4 million of entitlements. Bruck's owner, Philip Bart, was also a major shareholder in National Textiles in 2000 when into also went into liquidation. This matter was widely reported at the time as the then-Prime Minister's brother chaired that organisation. The loss of employee entitlements in that case was formative in the creation of the FEG model.

6.3 Transfer of ownership

6.3.1 Question 35 – Are there any barriers to the sale or transfer of a business? Are there any particular issues faced by the owners of unincorporated businesses in selling the business or transferring the business to a family member or members?

We refer to our comments above at 6.1 regarding phoenixing and the issues that arises where a business is sold or transferred to an associate leaving the original company with its debts and no assets.

It is important to note that there are obligations on a director of a company to ensure that assets are sold for value, particularly when a business is either insolvent or on the verge of insolvency. The business that is being transferred may be the only asset of the company, and its transfer to an associate for little or no value, may leave the creditors of the original company with only a corporate shell to against which to claim.

Where a company enters into a formal insolvency appointment, the liquidator or administrator will investigate transactions such as the sale or transfer of the company's business to ensure that it has been made for value and that the proceeds of the sale were received by the company. In the event that this has not occurred, a liquidator is able, subject to available funding, to take action to recover such transactions[31].

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[30] http://www.abc.net.au/worldtoday/content/2014/s4094465.htm

[31] Uncommercial transaction under section 588FB of the *Corporations Act 2001*

As has been mentioned previously, a process has arisen in the UK called pre-packs, where the sale of the business is negotiated prior to the appointment of an insolvency practitioner and effectuated immediately on appointment of that practitioner. The insolvency practitioner is involved in both the negotiation of the sale and effectuating the sale. Many of these sales occur to related parties, and in most pre-packs there is no return to unsecured creditors. Importantly from ARITA's perspective, in the UK process there is no independent review of the transaction to ensure that it was in the interests of all of the creditors. That is why ARITA does not support the introduction of pre-packs in Australia. We discuss this in our Policy Positions paper and in great detail in our Thought Leadership paper which has previously been provided to you.

6.3.2 Question 36 – Are there any specific barriers relating to the sale and transfer of government assets to the private sector? What has been the experience from previous sales of government assets?

ARITA does not have expertise in this area and is unable to comment on the matters raised in the issues paper.

6.4 Government support as a barrier to closure

6.4.1 Question 37 – To what extent does government support and subsidies impede business closure? In what sectors of the economy are such arrangements impeding business closure?

While we are not able to provide qualitative data to reinforce views in this regard, it is the consistent anecdotal experience of our members that subsidies tend to provide a disincentive to early and proactive restructuring that would prevent future collapse within distressed industries. It is clear that sectors such as the car industry have failed to respond to clear market signals that pointed to a need to restructure their offerings and their lack of responsiveness appears evidently tied to the previous continuation of large scale subsidies. Indeed, the significant aspect of concern in this behaviour is the failure to send appropriate signals through their supply chain.

Many examples of this are also evident in agri-business, where necessary restructuring is put off due to subsidies and relief packages, perpetuating agri-business entities which are not sustainable. Consequently, in the current economy where insolvency levels are low, agri-business insolvency remains one of the few “busy” sectors for insolvency practitioners.

We are also concerned about speculation in some political circles that legislation should be enacted to protect certain classes of business from insolvency. One example is a plan that has been mooted to prevent foreclosure on any farm. This type of policy has significant unintended consequences, the most of obvious of which is that lenders and other creditors would begin to avoid this sector and not extend credit to farmers – it simply would not be in their interest to do so and, for banks/other lenders it would make lending into this asset too risky and not allow them to meet their prudential requirements.

In our members’ experience, the Australian Taxation Office (“ATO”) is often slow to take action with businesses that fail to meet their tax obligations, to the detriment of other creditors. The ATO will enter into repayments arrangements with businesses that are close to, or already, insolvent – unfairly extending a business’ operation to the detriment of its other creditors. This is particularly unfair as the ATO would be privy to information that the general trade creditor would not and thus other creditors are making uniformed decisions about continuing to offer credit during this extension of operations.

In our submission we have consistently stated that it is important that companies demonstrate good corporate governance, and this includes compliance with their taxation

obligations. There needs to be appropriate balance between the ATO allowing viable businesses an opportunity to repay their debt by entering into repayment arrangements, and taking action to wind up unviable businesses in a timely manner. We note that the ATO states that it performs viability assessments before entering into payment arrangements. However, the large number of recoveries of preferential payments made by liquidators from the ATO would indicate that payment arrangements are occurring while the company or debtor is insolvent.

6.4.2 We note from the Inspector General in Taxation's (IGT) website that the ATO's approach to debt collection will be being considered as part of the IGT's 2014 work program.Question 38 – Are there any other potential or existing barriers to business closure?

ARITA refers the Commission to our Policy Positions Paper at Appendix A and to our precursor discussion paper "A Platform for Recovery 2014".

6.4.3 Question 39 – Given that governments use support and subsidies to meet particular policy objectives, what processes could be used to examine less distortionary alternatives? Are there approaches that could apply greater transparency to the use of government support and subsidies and their broader costs and benefits?

ARITA does not have knowledge in this area and is unable to comment on the matters raised in the issues paper.

7 Attitudes to risk and innovation

Key Point 7A: Entrepreneurism should not be at the expense of good corporate governance and good lending practices

Key Point 7B: Australia's insolvency regime needs to encourage earlier intervention for viable businesses in financial distress

7.1 Question 40 – Need for improve the overall attitude to risk and innovation in Australia

As to attitudes to risk and innovation, the Commission says that certain cultural attitudes will exist. This is likely to be reflected in the willingness of individuals and businesses to innovate and take on risk and the existence of an entrepreneurial culture. The focus of business set-up in an entrepreneurial culture would be on businesses experimenting through providing new products or services, using new technologies and introducing new business models. Such a culture would recognise those who achieve financial success through setting up a business while allowing those who fail to do so to attempt again.

ARITA is strongly of the opinion that the failure of one entrepreneur should not be at the expense, or result in the failure, of another entrepreneur. If there is no responsibility imposed on entrepreneurs, there is the risk that the pendulum will swing completely the other way with entrepreneurism being sought to the expense of everything else, including good corporate governance.

Being able to operate a business as a separate legal entity with limited liability is a privilege, not a right. As such there needs to be balance between risk taking and responsibility for choices made.

The focus of the Commission appears to be on the failure of business and the ability of entrepreneurs to "have another go". ARITA would like to rebalance that focus to encouraging directors to take steps to deal with financial distress earlier, so that viable businesses can be turned around rather than failing.

ARITA's view, expressed through our thought leadership work and Policy Positions paper, is that changes do need to be made to Australia's approach to support the rehabilitation of viable businesses. Once a business is unviable, we see that the system needs to work efficiently to ensure the reallocation of capital, and where appropriate investigate and report on the reasons for failure.

Despite the critical role the insolvency regime plays in the efficient allocation of capital, there is a widely held stigma associated with insolvency in Australia. Whether it is bankruptcy for

an individual[32] or voluntary administration/liquidation for a company[33], calling in an insolvency practitioner is not well regarded by the Australian community. As a result, this impacts on the ability of a company to be able to use formal restructuring and insolvency mechanisms such as voluntary administration (under Part 5.3A of the *Corporations Act*) to facilitate the turnaround of the business.

This can be contrasted with the US, where there is a different emphasis on how to react to insolvency[34]. ARITA research in Australia shows that currently it may well be correct that voluntary administrations are not resulting in the turnaround of the business for a large proportion of companies using them[35].

We see this arising from a combination of factors including:

- the stigma of insolvency resulting in directors responding to underperformance of their business by delaying in seeking expert advice;
- a lack of a "turnaround culture" in Australia, which may largely be driven out of a fear of liability for insolvent trading so that directors are not prepared to seek alternatives to formal insolvency once there is financial distress;
- the value destruction of a business caused by customers' and suppliers' exercise of ipso facto clauses;
- possible concerns around the potential for a customers' and suppliers' exercise of ipso facto clauses;or insolvent trading so that directors are not prepared to seek alternative; and
- directors of companies not being aware of the options available in addressing "endemic" and "temporary" distressed situations.

By undertaking reforms that:

- improve the effectiveness of voluntary administrations as a formal restructuring tool (Policies 15-07 and 15-08);
- create an environment where directors are able to undertake restructuring of a business outside of formal insolvency without the risk of incurring personal liability for

[32] Sylvia Pennington, 19 June 2013, Go for broke – insolvency can be the best solution, The Sydney Morning Herald

[33] Clive Lee, 12 December 2008, Australia: A second chance through voluntary administration?, Mondaq

[34] Cameron Cheetham, 2 February 2012, Ipso Facto clauses and insolvency, Clayton Utz Insights.

[35] Mark Wellard, Terry Taylor Scholarship 2013, *A review of deeds of company arrangement,* which found that in 72% of cases a deed of company arrangement delivers a quasi-liquidation outcome. However, for 28% of deeds a successful restructuring appeared to be the outcome.

insolvent trading if certain strict criteria around obtaining advice and financial management are met (Policy 15-04);

- result in quality directors being able to be attracted and retained by businesses in times of financial stress; and
- foster a culture whereby all stakeholders in the process work together to achieve an outcome,

ARITA considers that Australia will develop a restructuring environment which will enhance the operation of an already world class insolvency regime. However, for this to be accepted and successful, all stakeholders will need to make a conscious effort to change current public perceptions of mistrust and punishment and encourage the support for a business to be given a second chance where appropriate.

7.1.1 Is there a need to improve the overall attitude to risk and innovation in Australia to increase business set-ups in Australia?

ARITA does not have expertise in the area of risk and innovation in relation to business set-ups, but we note that any change in attitudes should not be at the expense of good corporate governance and particularly of good lending practices to avoid the cost to other areas of the market of a likely insolvency (future exposure of creditors).

We believe that some failure is necessary, and good in order to achieve the efficient and proper allocation of capital, and that it is needed to reach a balance.

7.1.2 How should risk taking be appropriately rewarded and mistakes not excessively penalised?

Risk is generally rewarded via the success and prosperity of a business venture, the greater the risk the greater the reward.

It is important to note that only approximately 0.47% of company[36] registrations end in insolvency, with many of these failures anecdotally attributable to incompetence[37] or malfeasance rather than "mistakes".

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[36] ASIC website – As at 30 June 2014 there were over 2.1 million companies registered in Australia, with 212,543 new registrations during the 2013-2014 financial year. There were 9,822 companies that entered into an external administration during the 2013-2014 financial year.

[37] ASIC Report 412: Insolvency Statistics: External Administrators' Reports (July 2013 to June 2014) available at http://download.asic.gov.au/media/1914730/rep412-published-29-september-2014.pdf, cites the top three reasons for failure as inadequate cash flow, poor strategic management of business and trading losses.

The present insolvency provisions do not excessively penalise entrepreneurs, as penalties are only in place to report and pursue misconduct. It is arguable that many instances of misconduct often go unpenalised as in reality very few conduct matters are actioned by ASIC[38]. The failure by ASIC to action such matters could be seen to support, rather than deter, entrepreneurism.

We note that despite the lack of penalties currently in the Corporations Act, the IRLB 2014 excludes a proposal put forward in the 2013 version of the Bill to impose an automatic suspension on directors where they fail to provide an external administrator with a statutory required report about the company's affairs (Report as to Affairs or RATA). This report is a fundamental investigation tool for external administrators and we cannot understand, or support, the removal of what we see to be an appropriate penalty for the effective disregard of a breach of this requirement. Furthermore, the information required to be provided in the RATA, should be information that can be readily obtained by a director of a company that is meeting its corporate governance and record keeping requirements and hence is no significant impost to competent directors.

We note how this contradicts with the position in bankruptcy, where there is an automatic penalty of the period of bankruptcy not commencing until the bankrupt lodges their Statement of Affairs (SOA), which is the equivalent to a RATA in corporate insolvency. Therefore, if a bankrupt fails to lodge their SOA, their bankruptcy will never end, but the penalty imposed on a director for a similar failure is minimal, if ASIC prosecutes.

7.1.3 How should the balance between rewards and sanctions be set to maximise overall community welfare?

We have considered the issue of penalties for business failure throughout our submission and our view is that ultimately it is a community decision as to where the appropriate balance lies.

7.2 Questions 41 – Is there a need to systematically encourage a more innovative culture, for example, through the education system?

ARITA fully supports the encouragement of a more innovative culture as long as the importance of good corporate governance and management is also encouraged.

7.3 Questions 42 – Should governments provide incentives, such as grants, through the tax system and insolvency arrangements, to increase the willingness of

[38] ASIC Report 412, ASIC Annual Report 2013-2014

individuals and businesses to take on risk and innovate?

A fundamental basis of an efficient market is the principle of risk v return. ARITA is strongly of the view that there should be no concessions for insolvency.

7.4 Questions 43 – What should governments not do to reduce barriers to business set-up and closure?

The government should not ignore the initiatives in ARITA's Policies Position paper as we believe that these policies will aid in the effective reallocation of capital in business transfers and closures.

Appendix A – Policy Positions of the Australian Restructuring Insolvency and Turnaround Association as at February 2015

Appendix B – Submissions and publications

Relevant ARITA/IPA submissions

'Safe harbour' submission - ARITA (then the IPA)'s submission to Treasury jointly with the Law Council of Australia and the Turnaround Management Association Australia dated 2 March 2010; supplementary submission of ARITA dated 18 March 2010

ARITA (then the IPA)'s submission to CAMAC of 7 October 2011 in respect of its June 2011 Managed Investment Scheme discussion paper

ARITA's submission to CAMAC of 10 June 2014 in respect of its March 2014 discussion paper on the Establishment and operation of Managed Investment Schemes

Strengthening APRA's Crisis Management Powers – Consultation Paper – September 2012, ARITA (IPA) submission December 2012

ARITA submission to UK consultation paper - Strengthening the regulatory regime and fee structure for insolvency practitioners, 28 March 2014

ARITA submission of 26 August 2014 to the Financial Systems Inquiry Interim Report

ARITA supplementary submission of 13 October 2014 regarding the use of technology, to the Financial Systems Inquiry

Relevant government reports

Productivity Commission Research Report August 2010, *4.5 Insolvency practitioners*

Senate Economic References Committee, The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework, September 2010 report

Senate Economics References Committee Report - "Inquiry into the Performance of the Australian Securities and Investments Commission" July 2014

CAMAC Report - Managed Investment Schemes, July 2012

Red Tape Challenge - changes to insolvency law to reduce unnecessary regulation and simplify procedures Consultation Paper, The Insolvency Service, UK, 2014

Relevant Australian Insolvency Journal and academic articles

Mark Wellard, Terry Taylor Scholarship Report 2013, *A review of deeds of company arrangement*

Amanda Phillips, Terry Taylor Scholarship Report 2012, *An analysis of official liquidations in Australia*

Bankruptcy and Insolvency, Change, policy and the vital role of integrity and probity, (2010) 22(2) A Insol J 4, Michael Kirby

An Ounce of Prevention – Practical Ways to Hinder Phoenix Activity, (2013) 25(3) A Insol J 16, Helen Anderson

Relevant other publications

Keay's Insolvency: Personal and Corporate Law and Practice, Michael Murray and Jason Harris, 8th ed, Thomson Reuters, 2014

The trust as a surrogate company: The challenge of insolvency, Dr Nuncio D'Angelo, 2014

The Economic and Strategic Structure of Insolvent Trading, Michael J Whincop, 2000

Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 Modern Law Review 665

'Graham Review into Pre-pack Administration – Report to The Rt Hon Vince Cable MP, June 2014' (the 'Graham Report')

'Pre-Pack Empirical Research: Characteristic and Outcome Analysis of Pre-Pack Administration - Final Report to the Graham Review April 2014' prepared by Professor Peter Walton and Chris Umfreville of University of Wolverhampton, UK.

Defining and profiling phoenix activity, Melbourne Law School, Monash Business School, Research Report 2014

American Bankruptcy Institute Commission to Study the Reform of Chapter 11 of the U.S. Bankruptcy Code: Report and Recommendations 2014