10 July 2015

Dr Warren Mundy
Presiding Commissioner
Business Set-up, Transfer and Closure
Productivity Commission
GPO Box 1428
CANBERRA ACT 2601

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

Dear Dr Mundy

Business Set-up, Transfer and Closure

Thank you for the opportunity to submit our views on these issues.

It is the AICM's view that reform is needed in a number of areas related to Business Set-up and Closure to minimise unfavourable and unproductive outcomes as we see today.

The main areas of concern for our members are:

- The ease of formation of companies,
- Non-disclosure of information in the lead up to an insolvency
- Practices currently permitted by the corporations act during the insolvency process.

1. About the AICM

The Australian Institute of Credit Management (AICM) is Australia's leading professional member body for commercial and consumer credit management professionals across all industries and sectors, and the only credit industry specific Registered Training Organisation in the country.

The AICM was founded in 1937, incorporated in 1967 and has established a trusted reputation as the professional body for setting professional standards and providing for the education, career needs and interests of all who work in the Credit Industry.

The AICM represents, develops and recognises the experience of over 2,400 individual members working in over 1,300 companies including 34 of the ASX 100 and global organisations in all industries and sectors.

Our members are Credit Professionals in roles relating to consumer and commercial credit including the obtaining or providing credit, collecting debts, financing invoices, enforcement of payment obligations, credit scoring and managing security interests.

While the AICM membership represents businesses of all types, including Banking and Finance, this submission is made with a focus on the view point of our members working in businesses that supply goods and/or services on extended payment terms i.e. they are credit/finance suppliers as a result of their core business which is not banking or finance. We refer to these organisations Trade Credit Providers ("TCP's) or who (aside from PPSA rights) would be unsecured creditors in an insolvency.

2 AICM's general policy on relevant issues

Ease of formation of companies

TCP's are highly reliant on publicly available information often sourced from the major Credit Bureaux such as Dun and Bradstreet and Veda in their assessment of Credit Risk. When assessing Small to Medium Businesses, a key factor of the credit decision is the Directors prior commercial history and Directorship history.

This information may add creditability to a credit application in the case of other directorships in established and well performing businesses. Conversely, it may highlight potential cause for concern if the directors have a history of being involved with failed companies. There is a significant correlation of businesses with adverse information in their director's histories defaulting on their payment obligations.

Due to the current absence of controls around director identification our members have identified errors being made deliberately and innocently causing the Directorship History to be incorrect. This may be due to misspelled or omitted director's information.

The ease of company set up and lack of Director Identification is also a factor in facilitating Phoenix activity. By ensuring correct information is recorded Directors history is more likely to display indicators of Phoenix activity and allow Trade Credit to investigate identify and potentially report potential Phoenix activity.

It is the AICM's opinion that the implementation of a Director Identification Number requiring sufficient proof of identity will result in improvements in credit decisions and reduce opportunity for Phoenix activity.

Lack of information in the lead up to Insolvency

The AICM firmly believes that there is a significant gap in the information available to assess risk of insolvency as well as Phoenix activity.

When a business defaults on its credit obligations TCP's regularly make this information available to other Trade Credit Providers by the recording of payment defaults and other payment data with various Credit Bureaux.

Currently the one creditor common to all businesses and potentially most relevant to all Credit providers is unable to provide this information to the system being the Australian Tax Office as well as other State and Federal Revenue offices.

The AICM firmly believes the community value of supplying information relating to businesses that are not maintaining their tax obligations would be significant for all areas of the community for example:

- Greater recovery of Tax Debt will reduce the governments reliance on other revenue raising
- The knowledge that delaying Tax obligations will make obtaining credit and finance harder will ensure great tax compliance
- Credit Providers will be better able to manage their risk exposures putting less pressure on price increases.
- Phoenix activity and/or losses as a result of Phoenix activity will be reduced specifically in instances where the ATO is the only creditor not paid out of the insolvent company. This will be achieved by the default to the ATO being detected in Directors credit histories when there is a common directorship or other identifiable connection between entities. Further it will be evident that the prior company was closed due to an insolvency.
- Insolvency action will be reduced as the impacts of poor cash flow will occur earlier e.g. trade creditors reducing payment terms leading restructuring occurring prior to technical insolvency.
- Losses from insolvency may be reduced through earlier action and creditors being better able to manage their exposures.

The AICM strongly recommends that the ATO (and other government revenue offices) are properly considered Creditors not purely regulators and authorised to release suitable and timely information about ABN holders tax obligations.

Practices permitted by Corporations act

It is in this area that the AICM's membership largely disagrees with the comment that *"the insolvency regime is operating well".*

Our members regularly experience actions that are in accordance with the Corporations act they but are clearly unfair, inefficient and of no benefit to the majority of stakeholders. Further our members feel that unsecured creditors unfairly bear the cost of the liquidation process.

While not currently identified as an issue of this review we strongly insist that significant reform is due.

The ASIC in its information sheet 45, *"Liquidation a guide for creditors" defines a Preference payment as "a creditor receives an unfair preference if, during the six months prior to liquidation, the company is insolvent, the creditor suspects the company is insolvent, and receives payment of their debt (or part of it) ahead of other creditors. To be an unfair preference, the payment must put the creditor receiving it in a more favourable position than other unsecured creditors."*

The ATO define a preference payment as *"Unfair preferences usually involve transactions that discriminate in favour of one creditor at the expense of other creditors. The aim of the law outlined below is to ensure creditors are treated equally by preventing any unsecured creditors from receiving an advantage over others."* https://www.ato.gov.au/tax-professionals/your-practice/insolvency-practitioners/preference-payments/preference-payments-for-companies/ accessed 3/7/15

Conceptually the preference payment seems reasonable but in practice this is resulting in undue burden on businesses. The AICM's concerns are best summarised as:

- The time frame for liquidators to commence recovery action is currently 3 years from the commencement of insolvency. This time period is un-reasonable as demonstrated by the example below.
- Preference claims are routinely pursued which result in no return to creditors. Effectively meaning unsecured creditors are funding the insolvency.
- The test of suspicion of insolvency is too onerous
- Organisations that undertake effective collections activity are penalised in favour of liquidators and/or other organisations that may not have taken any collections activity.

In summary the current regime is un-productive and burdensome on organisations who are following normal commercial practice. This is best summarised by a hypothetical but realistic situation:

Creditor Orange Pty Ltd sells Bananas to a company Monkey Pty Ltd, the parties have a long and happy relationship stretching back many years.

In January 2010 Monkey Pty Ltd has an account of $100k owing to Orange Pty Ltd.

In February the Orange Pty Ltd's credit team take steps in order to ensure the amount owed is paid. These steps include several calls, emails, letters and eventually withholding supply of more Bananas until the account is paid. During this time promises to make payments are broken, Orange hears that senior employees of Monkey have resigned and a cheque has bounced.

On 4 February Monkey Pty Ltd pays $85,000 as they are really hungry and need more bananas.

On 1 April 2010 Monkey Pty Ltd is placed into liquidation. Orange is still owed $50,000 at this time.

30 June 2010 Orange Pty Ltd writes off $50,000 as the liquidator advises (informally) that there is a little chance of Creditors being paid.

On 1 March 2013, 2 years and 11 months later (after 1065 days and 3 end of financial years passed) Orange Pty Ltd receives a Preference Claim from Mr White, Liquidator of Monkey Pty Ltd for $128,345 (being the amount of payments made by Monkey Pty Ltd to Orange Pty Ltd in the 6 months prior to liquidation).

Mrs Hardworking, Credit Manager of Orange Pty Ltd (Note: she is the 2nd Credit Manager in the role since transactions occurred) insists that they were just doing the rational thing in recovering amounts fairly owed and did not suspect insolvency. Mr White asserts the payments are preferential as they must have known the company was insolvent based on the recovery action taken and as evidenced by records of Monkey Ltd i.e. the letters, emails, bounced cheques and withholding of supply.

25 March 2013 Mr White applies to the court for an extension of time to pursue preferential payments as the 3 years allowed to pursue the payments is about to expire.

Knowing the legislation is in Mr White's favour Mrs Hardworking puts on a strong defence and is able to have the claim reduced to $85,000 being the amount paid after the account was in default and placed on stop supply.

Mrs Hardworking then has to choose between defending the claim through court proceedings which may result in the full $85,000 plus costs having to be paid to Mr White or negotiating for a settlement.

15 October 2013 Mrs Hardworking and Mr White finally agree to a settlement of $20,000 and Mrs Hardworking feels she has done all she can for her employer and takes some relief from the fact that her and other Creditors should receive a small return to creditors

20 October 2013 Mr White sends a final report to Creditors showing:
- Income: $20,000
- Liquidators expenses: $25,000
- Return to Creditors: $0.00

30 October 2013, Mrs White reports to the Board of Directors that they have to write off $20,000 plus legal costs in addition to the $50,000 written off in 2010 and the reason is that her team pursued and recovered money that was owed to them.

The AICM feels strongly that the Corporations Act should be amended to:

- Limit the time period for liquidators to commence action to recover preference claims to 12 months from the commencement of an insolvency process.

  The 12 month period could be extended by the duration of any Deed of Company Arrangement or by application to the court.

  In granting an extension the court should consider if the insolvency practitioner was negligent in accepting the appointment and should have i.e. were they capable of fulfilling their duties as a liquidator.

- Exclude payments made to Creditors in the normal process of recovering a valid debt from the definition of a preferential payment.

  With reference to the previous example, even if the full $20,000 is distributed to creditors is it really unfair for Monkey to have collected money as a result of their efficient account management including actions reasonably expected of an Arm's Length creditor as opposed to other creditors that did not manage their account or make recovery efforts or to related creditors.

- Limit preference claims to circumstances where the creditor was aware of insolvency (rather than reason to suspect insolvency).

  The AICM notes the definition of preference claims in New Zealand is in line with this recommendation.

- Limit preference claims to circumstances where the creditor was aware of insolvency and used influence other than that available to creditors generally.

  This would limit the liability to circumstances where the creditor has used their unique position in order to obtain a preference over general creditors an example may be a creditor supplying a unique component withholds supply and seeks payment earlier than it has previously or the franchising example noted in the next section.

The AICM notes that the above recommendation may have the impact of reducing the options available to fund the insolvency process, however this does not justify the current arrangements which see “victims” of insolvency bear significant cost of the insolvency and also receive the lowest preference in terms of distribution from and insolvency, regularly receiving no return (even when they have returned a preferential payment) and a 10 cent in the dollar return is considered a good outcome.

The small liquidation recommendation and increasing the funding of the asset less administration fund as recommended in the Draft report are significant measures that could be used to address this funding issue.

The Preferential Payments regime definitely has a place but we feel this should be limited to situation where the Creditor is not at Arm’s Length or has used a position or tactics not in line with those reasonably expected by a Creditor in the normal course of trading a business.

We thank the Commissioners for considering these points, especially where they are not currently identified in the draft report. These are views held very strongly by our members who have received some support and/or understanding from members of the Insolvency profession.

3 Responses to points raised during hearing on 30.6.15

While the AICM did not make representations at the hearing we note the following points of clarity were sought by the commissioners. Additionally discussions were held with Productivity Commission officers following the hearing.

Trading trusts

We emphasis ARITAs comment in their initial submission on Trading trusts specifically: *“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”.*

Trading with trusts is well known as a significant risk for our members. The complexity and uncertainty of transacting with Trusts as well as recovery means many of our members organisations either refuse to trade with these business (i.e. require Cash on Delivery or open in accounts in individuals names only) or restrict the credit provided through reduced credit limits or payment terms.

One complexity in transaction with Trusts is the party that should be contracted with is the Trustee of the trust however there is no systematic way of identifying the Trustee. Currently the vast majority of our members rely on customers to supply information relating to the Trustee and to advise them of any changes. The obtaining of Trust Deeds to determine a Trustee and contract terms requiring notice of a change are not effective with many Small Businesses not having ready access to trust deeds and breach of the contract terms is often uneconomical to pursue and comes too far after the event for the creditor to take appropriate steps.

The AICM recommends that the ABN register be amended to include details of the Trustee and this must be supplied and maintained to obtain an ABN. This would give credit providers much more confidence in trading with businesses in a trust structure.

Franchisor actions preceding insolvency action

A comment was made by an Associate Professor of the University of New South Wales that franchisors often terminate agreements with Franchisees prior to the insolvency of the Franchisee. This action allows the Franchisor to resell the Franchise territory without the funds to be distributed to all creditors. We strongly support the comments of the Associate Professor that this action needs to be addressed as it is clearly an action taken with knowledge of the pending or likely insolvency and in the interest to defeat other creditors of the franchisor.

Clearly this is a transaction that should be subject to liquidators ability to reverse the transaction or claim funds as this is an action taken by a creditor not at arm's length and likely to be acting with actual knowledge of insolvency not merely a suspicion.

The AICM recommends consideration of amending the Corporations Act to enable these sales to be deemed preference payments to the extent of the debt owed at the time of termination if the subsequent resale is made within 6 months of the termination.

This recommendation is consistent with other recommendations made earlier in regards to preference claims, namely that a Franchisor has a unique position, are in a position to know of actual insolvency and their ability to terminate a fundamental component of the business is a practice that is not available to creditors generally.

4 Comments on Recommendations in the draft report

5 DRAFT RECOMMENDATION 15.2

The AICM supports the expansion of the Administration process to companies that are solvent but may become insolvent but may become insolvent at some future time however feels that change is not warranted.

The AICM does not support the exclusion of insolvent companies from the Administration process, as this will reduce the ability if insolvent but viable businesses to restructure.

The AICM agrees with comments made by others that Administration is currently seen as a pathway to liquidation and there is a significant stigma placed on the administration process. This stigma may lessen the impact of attempts to make Administration only available to solvent companies seeking restructure to avoid potential of future insolvency.

The stigma associated with the Administration process this is based on the reality that there is significantly increased risk transacting with businesses that have experienced an Insolvency event, As noted in the draft report "Almost 60 per cent of Australian companies that enter voluntary administration are deregistered within three years of the commencement of the administration". Our members can attest that the incidences of companies that face a temporary informal insolvency that subsequently enter a formal insolvency process mirrors or exceeds this i.e. the vast proportion of companies that default on payment obligations due to stated "temporary cash flow issues " subsequently enter Administration or Liquidation in the short term.

The administration process is the most relevant way for technically insolvent companies with the ability to restructure to do so as it provides the opportunity to restructure but also ensures the insolvency is a matter of public record enabling fully informed future credit decisions.

While a period of Administration is considered an adverse indicator it does not mean credit would not be provided only that the Credit Provider would be able to assess the risk in full and implement risk mitigation options such as closer account monitoring, reduced Credit Terms or Credit Limits or requiring additional security. The AICM encourages Credit Managers look for risks as well as ways to conduct business in a way that mitigates this risk.

Directors of a company that may become insolvent but is not currently should (and will) act with commercial logic to restructure the business using normal business mechanisms and appropriate advise including restructuring of obligations with Creditors. If broader or more formal creditor restructuring is required then the Scheme of Arrangement or Administration processes is currently available.

DRAFT RECOMMENDATION 15.2

The AICM does not support the concept of a safe harbour for use during a period of actual insolvency due to the potential increase in risk and exposure for current creditors, it will not allow fully informed credit decisions and has implications on Preferential Payments

To allow an insolvent company to continue to incur debts whilst insolvent without the potential liability for insolvent trading and with the only remaining obligation of the Directors being "to act in the best interests of creditors as a whole" leaves significant room for Directors to increase the company's indebtedness whilst shifting all risk to the Creditor without the Creditor being made aware of the heightened risk of non-payment.

In the attempt to address this, the AICM recommends the following would be necessary:

- The safe harbour period only commences once notification has been lodged with ASIC and all current creditors have been notified.
- The obligation of directors should be amended to "Directors must ensure the company's indebtedness during the safe harbour does increase without notice of the insolvency when each supply is requested,
- Specific notification of the safe harbour should be provided to creditors when requesting new credit during a safe harbour period.
- If notice is not provided.to creditors and indebtedness increases, Directors and Advisors are immediately personally liable for any increases appointment of Administrator or Liquidator

Should the above issues of increasing indebtedness be addressed and in the instance of the company not subsequently entering a formal insolvency process not making the safe harbour period a matter of public record future creditors will not be in a position to fully assess the credit risk. This is vitally relevant information to all credit providers as noted earlier, companies that experience periods of insolvency are significantly more likely to face future insolvency periods and/or eventual deregistration or liquidation.

The AICM recommends that the use of a safe harbour period is made a matter of public record on the completion of the safe harbour. This will ensure all creditors (current and future) are able to make fully informed credit decisions but does not lessen the potential restructure.

- Further, payments made during this period to ensure continued supply and that indebtedness does not increase may be subject to preference payment claims as creditors may now have actual knowledge of insolvency. The AICM recommends:
- Amendment of the Corporations Act to remove liability to Preference claims as noted earlier

Amendment of the Corporations Act to remove liability to preference claims relating to payments made during a safe harbour period.

DRAFT RECOMMENDATION 15.3

The AICM supports a 3 year time limit before directors could avail themselves of a subsequent safe harbour period.

The AICM further recommends that once directors avail themselves of an initial safe harbour period the advisor should be required to assess if the Directors should undertake remedial action within the companies processes and/or management and if Directors and/or staff should take reform steps e.g. Directors Course, Credit Management Diploma etc. Any remedial recommendations must be completed before the

The AICM recommends that if safe harbour is abused, particularly if indebtedness increases, there should be an assumption of insolvent trading giving rights to creditors the right to pursue directors and advisor personally for these debts. Further in these instances the onus of proof should be on the director/advisor to show that they didn't act improperly.

The AICM agrees there should definitely be repercussions for any actions taken to restructure that are not to the benefit of all creditors.

DRAFT RECOMMENDATION 15.4

The AICM strongly refutes the universal suspension of ipso facto clauses.

Ipso facto clauses are common in TCP's terms and conditions for trade supply agreements. Where supply is not vital to the continuation of the business, Creditors should maintain the freedom of choice to continue to supply or not.

It is the AICM understands that the vast majority of creditors will continue to supply during a period of Administration once it has been confirmed the Administrator will bear full liability most creditors would take a commercial view and be willing to continue supply. The AICM also understands that a minor number of creditors may choose to withdraw supply or seek to change the terms.

We make particular reference to members in the hire industry who may be compelled to continue supply are prior agreed rates based on long term hire even though the administrators hire period will be significantly less. This situation can be further complicated where the creditor incurs significant delivery, set up and installation costs normally recovered through longer term hire. Similar situations could arise with variation in volumes.

The AICM also notes that while the vast proportion of Insolvency Practitioners are responsible, not all Administrators are model payees, therefore members should maintain the ability to exercise due diligence in making continued supply.

The AICM also notes that Administrators have the ability to choose whether they continue to obtain supplies from the incumbent suppliers/creditors. The AICM is aware of Administrations exercising this choice to discontinue arrangements with incumbent suppliers in favour of their preferred suppliers. Therefore it is commercially reasonable to give both parties the ability to maintain freedom of choice.

INFORMATION REQUEST

The AICM is supportive of the concept of an insolvency panel on the assumption it can be structured to achieve a cost and time saving to the insolvency process.

The AICM recommends the inclusion of a panel member with focus on the concerns of unsecured creditors. This is would have significant benefit in ensuring a full consideration from the viewpoint of all stakeholders seek to address the concerns of many unsecured creditors that their interests are often not considered.

DRAFT RECOMMENDATION 15.5

The AICM broadly supports the recommendation of a 'small liquidation' process and particularly the focus of reducing costs which is a considerable concern for our members, specifically due to the regular occurrence of some (not all) practitioners seemingly having little respect for controlling costs and the relevance of these costs versus expected outcomes. Specific examples include:

- Seeking fee approvals for increases multiple times CPI without justification.
- Legal fees in relation to preference claims with little relevance to the amount being pursued

The AICM supports reducing unnecessary administration and increasing focus on providing relevant information i.e. causes of the insolvency, details of any assets, directors conduct and detail on funds available including detail. If creditors continue to receive little or no disbursements from liquidations and get less insightful information this will make the situation worse.

The AICM recommends that the amount of standard information included in Creditors reports be limited to references or sources of the relevant information as the current size of many reports affects the absorption of what key information sought by creditors.

The AICM further recommends that Telephone and Web conferencing be required to be offered to all creditors in addition to physical presence. Our members have found that many practitioners are reluctant to offer these facilities making the insolvency process more costly and time consuming particularly on operations that operate nationally and or located offshore.

DRAFT RECOMMENDATION 15.6

The ACIM fully supports the recommendation that receivers obligations be amended to include a requirement to consider all creditors.

The AICM supports the recommendation that sales outside the normal course of business be subject to a vote by creditors. The AICM suggests that this should not be waived if there will be no funds to distribute to creditors as this is particularly where consideration should be given to ensure that the sale is reasonable and does not unduly impact on the ongoing business or other avenues for recovery. The AICM recommends the discretion be made on other grounds such as when the sale/asset value is below a relevant proportion of total assets.

DRAFT RECOMMENDATION 15.8

The AICM strongly supports the implementation of a Director Identification Number (DIN).

A legal entity should not be able to be established without sufficient proof of directors ID's as this will improve overall quality of information e.g. understanding directors histories and related companies.

The AICM recommends that once established Directors are obliged to advise ASIC if they change their name or have previously been known by other names. Further where this is not disclosed appropriate civil penalties should be imposed. This recommendation will address the potential of individuals establishing a DIN then subsequently and legally changing their name particularly in the instance of Phoenix activity. The recommendation is made on the understanding that there is no practical way for ASIC or private entities to obtain this information.

The AICM also recommends that shareholders who already hold a DIN disclose their DIN. This recommendation addresses the concern of disqualified directors or directors of previously insolvent companies appointing "dummy" directors and holding shares in a false or misleading name.

DRAFT RECOMMENDATION 13.1

INFORMATION REQUEST

The AICM supports the concept of bankrupts continuing as a Director in limited circumstances, specifically where it can be shown that the causes of the bankruptcy do not indicate a lack of ability to full fill their duties as a director and recommend that this only be only available on application to the court.

Further this leave should not be provided where there are 2 or more unrelated non-bankrupt directors. This would lessen the chance of the directors recklessly allowing the business to trade whilst insolvent as may be the case of a sole director (or related directors) who is bankrupt thus would not be concerned about personal liability due to breaches of obligations.

Thank you for your consideration of our thoughts, recommendations and concerns. If you would like to discuss any matter further please contact me.

Yours sincerely

Nick Pilavidis

Chief Executive Officer
Australian Institute of Credit Management