

# **Submission to the Productivity Commission Draft Report Business Set-Up, Transfer and Closure**

## **Centre for Commercial and Property Law, Queensland, University of Technology**

### **Response to issues raised on Personal and Corporate Insolvency Regimes**

The Commission has released a Draft Report on Business Set-Up, Transfer and Closure for public consultation and input. It is pleasing to note that three chapters of the Draft Report address aspects of personal and corporate insolvency.

Nevertheless, we continue to make the submission to national policy inquiries and discussions that a comprehensive review should be undertaken of the regulation of insolvency and restructuring in Australia. The last comprehensive review of the insolvency system was by the Australian Law Reform Commission (the Harmer Report) and was handed down in 1988. Whilst there have been aspects of our insolvency laws that have been reviewed since that time, none has been able to provide the clear and comprehensive analysis that is able to come from a more considered review. Such a review ought to be conducted by the Australian Law Reform Commission or similar independent panel set up for the task.

We also suggest that there is a lack of data available to assist with addressing questions raised by the Draft Report. There is a need to invest in finding out, in a rigorous and informed way, how the current law operates. Until there is a willingness to make a public investment in such research with less reliance upon the anecdotal (often from well-meaning but ultimately inadequately informed participants and others) the government cannot be sure that the insolvency regime we have provides the most effective regime to underpin Australia's commercial and financial dealings, nor that any change is justified.

We also make the submission that there are benefits in a serious investigation into a merged regulatory architecture of personal and corporate insolvency and a combined personal and corporate insolvency regulator.

### **Chapter 13 Personal Insolvency**

#### **Draft Recommendation 13.1**

*Section 149 of the Bankruptcy Act 1966 (Cth) should be amended so that, where no offence has occurred, individuals are automatically discharged from bankruptcy one year following the filing of a statement of affairs. The trustee, and the courts, should retain the power to extend the bankruptcy period to up to eight years if there are concerns regarding the debtor's conduct or ability. The Australian Government should work with other governments and professional bodies to ensure that any regulations or other arrangements restricting the employment of bankrupts beyond the period of bankruptcy are justified according to specific and efficient policy objectives.*

### *Minimum length of bankruptcy*

We agree with draft recommendation 13.1 to reduce the automatic discharge period for bankruptcy from 3 years to 12 months. As noted in our previous submission, a 12 month minimum period of bankruptcy is consistent with approaches taken in comparable jurisdictions. In addition, as some of the bankruptcy and occupational restrictions are imposed for the period of bankruptcy only, a reduction in the minimum bankruptcy period will improve the ability of persons subject to bankruptcy to re-engage in business in a shorter period of time, and will also better facilitate a fresh start for debtors in a rehabilitative sense,<sup>1</sup> whether the bankruptcy is business-related or not.

As noted in the Productivity Commission's submission, the Bankruptcy Act did provide for early discharge for a period of approximately 10 years. The relevant provisions were repealed in 2003, as part of a series of amendments to the Bankruptcy Act designed to address concerns that bankruptcy was 'too easy' and that debtors were not using bankruptcy as a last resort.<sup>2</sup> However, as discussed in detail in a 2004 article by John King, there is little evidence to support these concerns that bankruptcy is 'too easy'.<sup>3</sup> There were some criticisms of the way in which early discharge had been implemented, including concerns about the criteria used to identify when a person would be able to apply for early discharge.<sup>4</sup> However, an appropriate response to these concerns would be to improve the implementation for an early discharge policy, rather than to prevent its availability at all. In any case, it is our view that a reduction in the minimum period of bankruptcy to 12 months should be available for all debtors, without the need for an application for early discharge. This would overcome some of the objections to the previous early discharge model.

If a reduction in the minimum period of bankruptcy is introduced, we support the continuation of a process for extending the period of bankruptcy for up to 8 years, in specified circumstances of debtor misconduct.

### *Occupational restrictions*

We also generally support draft recommendation 13.1 in relation to examining the current occupational restrictions imposed on persons who have entered bankruptcy or another personal insolvency arrangement. As we noted in our earlier submission, the circumstances in which bankruptcy (and other personal insolvency administrations) will be a mandatory or discretionary bar to participation in a particular occupation are difficult to identify, often inconsistent, and appear to lack a consistent and justifiable policy rationale.

There are variations and inconsistencies in the restrictions imposed across different occupations and across different jurisdictions within Australia. In addition, even in the absence of a specific occupational restriction, there are various occupations where participants are expected or encouraged to operate as a company and the ban on managing a company while bankrupt has an impact. Further, there are various professional associations (such as law societies) that require applicants for membership to disclose if they are, or have been, disqualified from managing a

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<sup>1</sup> See discussion of the different ideas of the fresh start in Nicola Howell, 'The Fresh Start Goal of the Bankruptcy Act: Giving a Temporary Reprieve or Facilitating Debtor Rehabilitation' (2014) 14(3) *QUT Law Review* 29, 34.

<sup>2</sup> John King, 'Moving beyond the 'hard'- 'easy' tug of war: a historical, empirical and theoretical assessment of bankruptcy discharge' (2004) 28(3) *Melbourne University Law Review* 654, 670.

<sup>3</sup> See generally King (2004) 670-674.

<sup>4</sup> King (2004) 674.

company. This may have an adverse effect on persons entering or remaining in particular occupations where membership of a relevant professional association is expected, if not compulsory.

In its recent report on personal insolvency, the World Bank noted ‘the principle of *non-discrimination* is an important consideration in achieving the full benefit of a discharge’;<sup>5</sup> and that this issue of discrimination against current and former bankrupts is one that required attention in the future.<sup>6</sup> We agree, and believe that attention paid to this issue needs to encompass the issue of discrimination includes discrimination in business and employment contexts.

We therefore strongly support a broad review of occupational restrictions imposed following bankruptcy or another insolvency administration. We also strongly support a policy-driven approach to determining when such restrictions are appropriate.

### *Chapter 14 -15 Corporate Insolvency*

#### *Information Request*

*Is there available data relating to the frequency and importance (in terms of the overall value of debt) of informal workouts? If not, how should the Commission obtain this information — for example by a survey of banks or insolvency practitioners?*

It is noted that an information request is made in 14.2 in relation to data on the frequency and importance of informal workouts. It is unlikely that this will be available and certainly we are not aware of any. The question as to how should this be obtained, a survey may be appropriate. However we point out again that this is one of many gaps in the data we have about what is actually occurring with our insolvency law. A much greater effort needs to be made to have evidence about the claims and counter claims as to the effect of our various pieces of legislation. There is a lack of investment in this data at all levels but particularly by ASIC. Nearly every inquiry into insolvency law in Australia including Harmer, has called for better data. Sadly no real effort has been made as yet to fundamentally improve matters (though most recently AFSA has indicated it may be prepared to assist in this regard). As we noted in our earlier submission to this enquiry: If the government wishes to improve our personal and corporate insolvency regimes, it must first invest in finding out, in a rigorous and informed way, how the current law operates. Until it is prepared to make such an investment and while instead it relies upon the anecdotal (often from well-meaning but ultimately inadequately informed participants and others) it cannot be sure that the insolvency regime we have provides the most effective regime nor that any change is justified.

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<sup>5</sup> The World Bank, Insolvency and Creditor/Debtor Regimes Task Force, Working Group on the Treatment of the Insolvency of Natural Persons 2013, *Report on the Treatment of the Insolvency of Natural Persons*, at [116].

<sup>6</sup> The World Bank, Insolvency and Creditor/Debtor Regimes Task Force, Working Group on the Treatment of the Insolvency of Natural Persons 2013, *Report on the Treatment of the Insolvency of Natural Persons*, at [117].

*Draft Recommendation 15.1*

*Section 436A of the Corporations Act 2001 (Cth) should be amended such that a company may only appoint an administrator (and commence an 'independent restructuring' process) when the directors form the opinion that the company may become insolvent at some future time, but is not currently insolvent.*

- *The option to appoint an administrator to restructure when the company is insolvent should be removed.*
- *If an administrator determines the company is insolvent, liquidation should be commenced.*

It is difficult to see much benefit in this draft recommendation and in practice it will be likely to create many uncertainties. Whilst the aim of encouraging directors to move more quickly into the voluntary administration process is a desirable one, there is no evidence (apart from the assertion by the law firm) that limiting the operation of voluntary administration in this manner will create a distinction between restructuring and winding up. There is no evidence that the market's perception of voluntary administration will change if only s 436A is amended in this way. This is reinforced by the fact that simply because an entity is not currently insolvent will not ensure that restructuring will occur. Further in a practical sense the definition of insolvency (or more accurately solvency) as per s 95A Corporations Act is far from clear or precise in most circumstances when a company is under financial distress. Thus requiring a pinpoint observation that the company is not yet insolvent is problematic.

The Draft Report earlier notes<sup>7</sup> Mark Wellard's figures that 28% of deeds result in "successful" restructuring.<sup>8</sup> This is assumed to be something of a "failure". The Draft Report fails however to identify how other regimes fare in this respect.<sup>9</sup> It seems that comparable jurisdictions do not do better. The sad reality is that the success of a restructure is due to many factors and both the US and the UK somehow are assumed to do better but the reality is perhaps not as the Report makes out.<sup>10</sup> Until there is an indication that the current Australian legislative regime is poorer than others and that the changes can "improve" the outcome, it is difficult to justify changes.

What this recommendation and its limitations demonstrate is that if the law is to change around voluntary administration a much more detailed consideration of the matters is required and it should be part of a much more comprehensive review of the insolvency law. Whilst the Draft Report raises some of the more important issues, it necessarily lacks the broad approach that is required. We strongly urge that there be a recommendation for a detailed examination of the insolvency law in Australia –similar to the Harmer Report- to identify all aspects of our law and provide appropriate evaluation.

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<sup>7</sup> At p46.

<sup>8</sup> Though ascribed to ARITA in the Draft Report.

<sup>9</sup> See for example Lawton, A., 'Chapter 11 Triage: Diagnosing a Debtor's Prospects for Success' (2012) 54 *Arizona Law Review* 985.

<sup>10</sup> And indeed as is submitted here does provide evidence to support.

#### *Draft Recommendation 15.2*

*The Corporations Act 2001 (Cth) should be amended to include provision for a 'safe harbour' to allow companies and their directors to explore restructuring options without liability for insolvent trading. During such a period, the directors would retain control of the company, but receive independent advice from registered advisers.*

*Advisers appointed in safe harbour would be disqualified to act as administrators, receivers or liquidators in any subsequent insolvency process for the company.*

*The company would be required to inform the Australian Securities and Investments Commission, and the ASX in the case of listed companies, of the appointment of an adviser.*

*In informing themselves and the adviser, and determining whether to act on any restructuring advice, directors would be under a duty to exercise their business judgment in the best interests of the company's creditors as a whole, as well as the company's members.*

*If the positive thresholds above are met (and evidenced), a director's duty not to trade while insolvent would be considered to be satisfied during the period of advice and for actions directly related to implementing the restructuring advice.*

While the mechanics of this Recommendation require careful consideration, action to encourage 'owners' and 'managers' of companies to address financial issues sooner than currently occurs and to salvage economic value is supported.

#### *Draft Recommendation 15.3*

*Provision should be made in the Corporations Act 2001 (Cth) for safe harbour periods to result in 'pre-positioned' sales (where a non-distressed sale is organised in the period immediately prior to a formal insolvency appointment).*

*External administrators in subsequent insolvency processes should have the ability to review the sales, and where there are no related parties, overturn them only if they can prove that the sale was not for reasonable market value.*

*If there are related parties, there is no presumption favouring sale and the administrator's examination of the sale process continues as normal. The administrator's review should include checks that the sale has met existing regulatory requirements for related party transactions.*

On this matter and in keeping with our introductory comments on the need for more detailed data, we recommend that comprehensive research such as that undertaken in the United Kingdom by Professor Peter Walton, University of Wolverhampton.

#### *Draft Recommendation 15.4*

*The Corporations Act 2001 (Cth) should be amended such that ipso facto clauses that allow termination of contracts solely due to an insolvency event are unenforceable if a business comes under the control of an administrator or receiver (as already applies if a person is in bankruptcy) or if the company is utilising the safe harbour arrangements set out in draft recommendation 15.2. In circumstances where this moratorium could lead to undue hardship, suppliers should be able to apply to the Court for an order to terminate the contract.*

Draft Recommendation 15.4 is supported.

#### *Information Request*

*Should a moratorium on creditor enforcement actions during schemes of arrangement be introduced?*

*What effects would this have in light of some of the Commission's other proposed reforms. Specifically, would it have a substantial additional impact on the effectiveness of schemes over and above a moratorium on ipso facto clauses? Would removal or streamlining of court involvement affect the benefits available?*

*Is there scope for additional use of alternative dispute resolution and other non-judicial options within the insolvency process? Is this possible under current law, would it require legislative change or would constitutional issues affect its design? In particular:*

- Would an 'insolvency panel', operated as a form of expert witness, reduce costs in insolvency process, particularly when considered alongside the Commission's other reform proposals? How could this be implemented?*
- Should any panel be able to hear matters across all insolvency issues, or would some subset, such as schemes of arrangement, be more appropriate?*
- How many court hearings would such a panel displace? Would this represent a wholesale replacement of the court, or simply an addition (in time and cost) to existing processes?*

The argument in favour of a stay in respect of Schemes of Arrangement has some merit. However, there is a difficulty in focussing on this one point and it goes back to what was stated above in respect of the limitations of this Draft Report. Such a change is dealing with one aspect of one type of procedure. It again lacks the comprehensive analysis of Schemes let alone how it might interact with other aspects of the insolvency and corporate law. It is not clear for example whether a ban on ipso facto clauses would apply in these circumstances; would there be an impact on secured creditors? And so on

We would certainly reject a suggestion that there ought to be an insolvency panel for schemes but this is based on the fact that it has not been properly considered here in terms of the broader context. The practicality of the proposal and the implications in terms of practitioner power requires careful thinking beyond what is provided here. This again is a proposal that requires more analysis. It effectively represents a movement towards specialist insolvency tribunals. If it is worthwhile for schemes, what about other procedures? Why should it be limited to just schemes- could it not be of benefit to situations where for example a Deed of Company Arrangement is being challenged? These issues are worthy of debate and indeed detailed research. Unfortunately, this Report does not provide it and it is unlikely that it is possible in the context of the terms of reference. It would be a great pity though if Australia's insolvency regime was effectively abandoned to a series of piecemeal analyses that fail to consider overall matters in any meaningful way.

*Draft Recommendation 15.5*

*The Corporations Act 2001 (Cth) should be amended to provide for a simplified 'small liquidation' process.*

*This would only be available for those companies with liabilities of less than \$250 000, creditors would be able to opt out of the process and into a standard creditors' voluntary liquidation, and the Australian Securities and Investments Commission (ASIC) would be able to initiate further investigation if it has concerns of illegality.*

*The primary role of the liquidator would be to ascertain the funds available, to a reasonable extent given a reduced timeframe.*

*In line with this, there would be no requirement for meetings of or reports to creditors, nor investigations into officers' conduct or other illegalities (unless ordered, and recompensed, by ASIC).*

*Liquidators for these processes would be drawn from a pool of providers selected by tender to ASIC.*

*The tenders would be subject to review every five years.*

Draft Recommendation 15.5 is not supported in its current form.

*Draft Recommendation 15.6*

*The Corporations Act 2001 (Cth) should be amended to alter the powers and duties of receivers: The duties to obtain best prices under section 420A should be subject to a duty not to cause unnecessary harm to the interests of creditors as a whole, including putting the continuation of the company, or the preservation of the company as an ongoing concern for sale purposes, at risk. The existing powers of a receiver should remain. However, any proposed courses of action, particularly involving sale of assets, that are outside the normal course of the debtor's business, would be subject to a simple majority vote of all creditors. This vote would be waived if, in the receiver's opinion, there would be no funds to distribute to unsecured creditors after secured creditors are paid.*

*Secured creditors would retain the right to appoint receivers as dictated by the conditions of the security. Such appointments may not be overturned by simple votes of creditors, but may be overturned if the court determines that the receiver is not acting in accordance with the duties above.*

*These changes would only apply to security contracts entered into after the date of assent of the amending legislation.*

It is again noted here that this recommendation is likely to cause a significant shift in the operation of a major part of our commercial system but it lacks a comprehensive analysis of the place of the rule in the insolvency framework. Whilst the role of receivership in a modern credit economy is worthy of study in the light of developments in other jurisdictions and the movement towards a Personal Property Securities system, the recommended change does not do justice to that. There is no evidence that the change that is mooted in any way will ameliorate the problem raised. This leaves aside the very real practical problem of what a "duty not to cause unnecessary harm to the creditors as a whole" would mean in hard practical situations and how it would be enforced. The recommendation ignores the data discussed on p77 which raises the issue of the place of receivership versus administration and the UK experience. Again it is a case of tinkering at the edges of an issue that needs to be placed in the broader context which includes the rights of secured creditors and unsecured creditors.

*Draft Recommendation 15.8*

*Section 117 of the Corporations Act 2001 (Cth) should be amended to require that, at the time of company registration, that directors must also provide a Director Identity Number (DIN).*

*A DIN should be obtained from the Australian Securities and Investments Commission (ASIC) via an online form at the time of an individual's first directorship. In order to obtain a DIN individuals should be required to provide 100 points of identity proof, and verify that they have read brief materials on directors' legal responsibilities provided as part of the online registration.*

*For existing companies, their directors should be required to obtain a DIN. The director DINs should then be provided to ASIC at the annual review date for the company, as a change to company details. To enforce these requirements, ASIC should be empowered under section 205E of the Corporations Act 2001 (Cth) to ask a person who is a director to provide their DIN.*

The recommendation to introduce a Director Identity Number to help address illegal phoenix activity is supported. There is an extensive range of corporate law, tax law, criminal law, employment law



and fiduciary obligations that addresses the underlying illegality of phoenix activity.<sup>11</sup> This law is capable of capturing most of the illegal behaviour underlying phoenix activity, despite the many forms in which that behaviour may manifest. Law reform targeting the behaviour underlying phoenix activity is unnecessary given the sheer extent of the existing law. Timely detection and enforcement of the law would communicate a powerful message essential for both effective deterrence of illegal activity and the promotion of economic confidence in the continued support for legal business failure. If there is to be any further reform, it ought to be directed at relieving the detection and enforcement burden borne by regulators such as ASIC. If the law is to have an effective deterrent effect, then regulators must be well placed to promptly detect transgressions and prosecute offenders.

The recommendation to introduce a Director Identity Number will assist regulators in tracking director involvement in the management of multiple companies. Accordingly ASIC will be better placed to exercise its extensive powers of investigation and enforcement.

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<sup>11</sup> See for example under the *Corporations Act 2001* (Cth): the power to wind up solvent companies: s461(1)(k); *Deputy Commissioner of Taxation v Casualife Furniture International Pty Ltd* (2004) 9 VR 549; winding up under s 447A; Uncommercial transactions under, s 588FB(1); See also ss 588FE and 588FC; directors have an obligation to avoid insolvent trading: s588G; fiduciary obligations require the directors to act honestly, in good faith and in the best interests of the company, avoid conflicts of interest and to exercise due care and diligence; directors and other officers of the company must comply with the statutory obligations in ss 180-183 to act with due care and diligence, in good faith and duties not to misuse their position or information so as to cause detriment to the company, to gain personal advantage or an advantage for another. Persons involved in a contravention of s180(2), 181(2), 182(2), 183(2) or 588G(2) are also in contravention of the provision. 'Involved' is broadly defined in s79 and can capture advisors such as those providing legal, financial or restructuring advice to the company; See *ASIC v Somerville* (2009) 259 ALR 574; *Dalmain Holdings Pty Ltd v Rechichi* [2010] WASC 376; directors and other officers commit an offence under s 184 if they are reckless or intentionally dishonest and fail to exercise their powers and perform their duties in good faith and in the best interests of the corporation and for a proper purpose; misuse of position or information can amount to an offence under s 184; ASIC's relevant administrative powers under the *Corporations Act 2001* (Cth), include power to wind up abandoned companies under s489EA, and power to disqualify a person from managing a corporation for up to five years where the person has been an officer of two or more insolvent corporations wound up in the previous seven years: s206F.