

Submission to the Productivity Commission Issues Paper Business Set-Up, Transfer and Closure

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Response to issues raised on Personal and Corporate Insolvency Regimes

The Commission has been asked to identify appropriate options for reducing entry and exit barriers including advice on the potential impacts of the personal/corporate insolvency regimes on business exits.

1. There is a 'close relationship between economic results and legal solutions' in the field of insolvency.¹ Insolvency law finally allocates the losses in the event of financial failure of a business. It also provides the backdrop against which a business rescue is attempted in the twilight zone of a business approaching insolvency. It underpins the commercial and financial dealings in a market economy² and the choices it makes are also a crucial indicator of the attitudes and fundamental values of the state's legal system.³ Nevertheless, insolvency law is not merely of economic significance to the community.⁴ It is intimately linked to the commercial, financial and social fabric of a state, being an important contributor to the state's commercial and economic processes and an important component of the state's general commercial laws.⁵
2. A national approach to personal and corporate insolvency and restructuring is justified by the close relationship between economic results and insolvency regulation. In the context of cross-border or international insolvencies, Professor Westbrook, University of Texas, Austin, refers to 'market symmetry', that is 'the requirement that some systems in a legal regime must be symmetrical with the market, covering all or nearly all transactions and stakeholders in that market with respect to the legal rights and duties embraced by those systems.'⁶ He notes that it is:

unsurprising that virtually every country has established a national [insolvency] regime co-extensive with its national market. Most tellingly, as with intellectual property law, virtually all federated countries, including those (like the United States) that give

¹ Burman HS, 'Harmonization of International Bankruptcy Law: A United States Perspective' (1996) 64 *Fordham Law Review* 2543 at 2548.

² Wood PR, *Principles of International Insolvency*, 2nd ed, Sweet & Maxwell, London, 2007 at 1.

³ Ibid.

⁴ Warren E, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 775; Gross K, *Failure and Forgiveness: Rebalancing the Bankruptcy System*, Yale University Press, New Haven, 1997.

⁵ See the guiding principles adopted in the Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45, vol 1, Australian Government Publishing Service, Canberra, 1988 at [33]. The World Bank's Principles on the Legal Framework for Corporate Insolvency state they should 'integrate with a country's broader legal and commercial systems': World Bank, *Principles and Guidelines for Effective Insolvency and Creditors' Rights Systems*, 2001 at Principle 6.

⁶ Westbrook JL, 'A Global Solution to Multinational Default' (2000) 98 *Michigan Law Review* 2276 at 2283.

considerable autonomy to regions (states) in business and commercial matters, nonetheless insist that the [insolvency] regime be national, to fit the national dimensions of the market.⁷

However as we point out below in respect of Q 30 and sanctions in personal insolvency or bankruptcy, there can be differences between states and territories due to the differing regulation affecting, for example, employment of an undischarged or former bankrupt.

28. *To what extent do the existing insolvency arrangements facilitate or hinder business closure? Are these arrangements a disincentive to business set-up? How do these arrangements affect the choice of business structure?*

3. In light of the increasing complexity of issues surrounding business failure and rescue, including for international business, we submit there are benefits in a merged regulatory architecture of personal and corporate insolvency and a combined personal and corporate insolvency regulator. The issue has been considered over the years, notably in the 2004 Corporate Insolvency Law Stocktake⁸ and was recommended by a Senate Committee in 2010.⁹ The AFSA submission to the FSI¹⁰ provides a useful overview of the insolvency frameworks in a number of jurisdictions compared to Australia. For the small business entrepreneur,¹¹ risk factors impacting the choice of business structure would include insolvency – operating as a sole trader potentially brings the personal insolvency regime into play with the particular personal impact that may bring;¹² whereas operating through a company would invoke the corporate insolvency regime. Differences still exist between these regimes, despite attempts at harmonisation through the proposed ILRB 2014. If a corporate structure is used in combination with personal guarantees by the ‘owners’, then concurrent personal and corporate insolvency administrations may come into play.
4. We suggest that there is a lack of data available to assist with addressing these questions under Q 28. However, a lack of data available on corporate insolvency has been continually noted in almost every Parliamentary report at least since the 1988 Australian Law Reform Commission *Report No. 45, The General Insolvency Inquiry*, commonly known as the Harmer Report. See also the Parliamentary Joint Committee on Corporations and Financial Services Report, *Corporate Insolvency Laws: A Stocktake* (2004) which identified [at 12.64] a ‘paucity of contemporary systematic comparative information and empirical data on the operation of corporate insolvency

⁷ Westbrook JL, ‘A Global Solution to Multinational Default’ (2000) 98 *Michigan Law Review* 2276 at 2284.

⁸ Parliamentary Joint Committee on Corporations and Financial Services 2004, *Corporate Insolvency Laws: a Stocktake*, at [12.73] ff; Productivity Commission 2010, *Annual Review of Regulatory Burdens on Business: Business and Consumer Services Research Report*, at 175.

⁹ Senate Economics References Committee 2010, *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework*

¹⁰ http://fsi.gov.au/files/2014/09/Australian_Financial_Security_Authority.pdf

¹¹ Micro, small and medium enterprises (MSMEs) is being addressed by the United Nations Commission on International Trade Law (UNCITRAL) “aimed at reducing the legal obstacles encountered by micro, small and medium-sized enterprises (MSMEs) throughout their life cycle”: http://www.uncitral.org/uncitral/en/commission/working_groups/1MSME.html . Policy issues include insolvency.

¹² The World Bank, Insolvency and Creditor/Debtor Regimes Task Force, Working Group on the Treatment of the Insolvency of Natural Persons, *Report on the Treatment of the Insolvency of Natural Persons*: http://siteresources.worldbank.org/INTGILD/Resources/WBInsolvencyOfNaturalPersonsReport_01_11_13.pdf.

laws’ and also Recommendation 58 at [12.72]. The Senate Economics References Committee in *The regulation, registration, and remuneration of insolvency practitioners in Australia: the case for a new framework* (2010) Chapter 9 notes the ‘familiar theme’ of the call for better data at [9.3] – [9.7]. The conclusion on insolvency data was that the Committee ‘strongly agrees’ that the lack of data needs to be ‘addressed in a comprehensive way’.

If the government wishes to improve our personal and corporate insolvency regimes, it first needs to 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 to underpin Australia’s commercial and financial dealings, nor that any change is justified.

5. The broad operation of the Australian personal and corporate insolvency regimes is not something that can be dealt with in this brief submission. 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.¹³

There has been significant piecemeal commentary on our current system by governmental committees in the time since 1988 which adds to the problem of not fitting all of the pieces of the insolvency puzzle together. Fundamentally the fitting together of the personal and corporate regimes needs to be better undertaken than it is currently. If some changes are proposed their full impact across the broad insolvency regime needs to be considered. So for example, if a more debtor-friendly restructuring regime is advocated, what are the implications for individual director who is also perhaps a debtor of major lenders to the company? And what of the issue of secured creditors and their power in respect of corporate rescue- how is that to be dealt with? What is needed is a form of review that will provide the comprehensive analysis that has been lacking since 1988. We have a template for what can be done based on the *Harmer Report* (or even the *Cork Report* from the UK). Anything less than that is likely to lead to nothing more than superficial tinkering. It almost goes without saying that there has been an enormous change in the way in which business is operated and financed since 1988 with the developments in capital markets and the growth in secured credit so that examination of possible fundamental change is well overdue. In this context, it is noted that in 2013 Singapore conducted a holistic review of its insolvency regime¹⁴ and on 25 August 2014 the Senior Minister of State for Law, Indranee Rajah, announced that Singapore is enacting major reforms of its insolvency laws as “Singapore tries to position itself as a regional hub for insolvency work and debt restructuring”.

¹³ The impact of such comprehensive law reform discussion is evident, for example, albeit in the New Zealand context, in a NZ Supreme Court decision of 18 February 2015 dealing with voidable transactions. In *Allied Concrete Ltd v Meltzer* [2015] NZSC 7 there were frequent references not only to the New Zealand Law Commission but also by Elias CJ to the Australian Law Reform Commission General Insolvency Inquiry Report.

¹⁴ Report of the Insolvency Law Review Committee, Final Report, 2013:
<https://www.mlaw.gov.sg/content/dam/minlaw/corp/News/Revised%20Report%20of%20the%20Insolvency%20Law%20Review%20Committee.pdf>

29. *Is the underlying incentive structure within the corporate and personal insolvency arrangements able to effectively and efficiently facilitate business closure without discouraging new business set-ups? Where should the balance lie between creditors and debtors in the arrangements? Are there feasible alternatives to the existing corporate insolvency arrangements? Is the use of safe harbour provisions for firms seeking to restructure a feasible alternative?*

6. On the existing corporate insolvency arrangements, we propose that the comprehensive review of the insolvency system should reconsider the need for the option of secured creditor receiverships to continue – in particular as they may run concurrently with voluntary administrations. Australia provides a prominent position to dominant secured creditors. While it is important to recognise secured credit in our insolvency regime, there are different ways of treating secured credit. We propose that any comprehensive review of the insolvency regime should consider to what extent can/should secured creditors have their rights suspended/reduced where a corporate rescue is being proposed. The position of secured credit has been debated extensively in academic literature¹⁵ and the question has been asked whether the power granted to secured creditors is justified or whether it simply comes at the expense of the unsecured. In 2002, the UK abolished administrative receivership in almost all circumstances. Qualifying holders of floating charges created on or after 15 September 2003 were no longer able to appoint a receiver, but could instead put the company into administration. It has been suggested that rise of the “pre-pack” process in the UK has been a response to this loss of power by the dominant secured creditor.¹⁶ What this demonstrates is the potential for change to one part of the insolvency regime (or even the broader commercial law) to have an effect in another part. This again reinforces the need for a wide comprehensive review so that all matters are covered.
7. Additional issues which have been canvassed over some time for law reform in Australia and which are relevant to this inquiry include:
 - The impact of the insolvency regime on the availability of post-commencement financing to facilitate the salvaging of economic value;
 - The potentially devastating effect of ipso facto clauses on business rescue, as was evident in the collapse of the telecommunications retailer, One Tel; and
 - The current settings of the insolvent trading laws which may act as a disincentive to rescue a business in the twilight zone approaching potential insolvency.

¹⁵ LoPucki L, ‘The Unsecured Creditor’s Bargain’ (1994) 80 *Virginia Law Review* 1887; Westbrook J, ‘The Control of Wealth in Bankruptcy’ (2004) 82 4 *Texas Law Review* 795; Armour, John, ‘The Law and Economics Debate About Secured Lending: Lessons for European Lawmaking?’ (2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1118030>; Armour J, Hsu A and Walters A, ‘The costs and benefits of secured creditor control in bankruptcy: evidence from the UK’ (2012) 8 *Review of Law and Economics* 101.

¹⁶ See Armour J, ‘The rise of the ‘Pre-Pack’: Corporate Restructuring in the UK and Proposals for Reform’ in Austin R and Aoun F (eds), *Restructuring Companies in Troubled Times: Director and Creditor Perspectives*, Ross Parsons Centre of Commercial, Corporate and Taxation Law, University of Sydney, 2012, at 61.

30. *How should the sanctions in personal insolvency or bankruptcy apply to individuals? For how long should these sanctions around bankruptcy apply? Are these sanctions a disincentive for entrepreneurial activity? Is there adequate enforcement of the existing sanctions? Are there feasible alternatives to the current bankruptcy process?*

8. Key sanctions imposed through the personal insolvency and bankruptcy regime include the obligation on individuals to disclose an undischarged bankruptcy (or current debt agreement) to creditors when applying for credit above the threshold amount (currently \$5,398);¹⁷ the obligation on individuals in business to disclose their bankruptcy to the persons with whom they have business dealings (unless they are operating the business under their own name);¹⁸ the accessibility of information about current and previous insolvency administrations through the National Personal Insolvency Index (a permanent, public record); and specific occupational restrictions on persons who have used bankruptcy laws. The extent to which these sanctions do impact adversely on individuals, including in the context of business continuations and business start-ups, is not known, and is another area where research is needed. Provisional statistics from the Australian Financial Security Authority show that 4,391 bankruptcies in 2013-2014 (approximately 22%) were business related bankruptcies, where the bankruptcy was directly related to the debtor's proprietary interest in a business.¹⁹ The sanctions imposed during bankruptcy, and in some cases after discharge of bankruptcy, are likely to make it difficult on these debtors to continue in business, or to start a new business after discharge from bankruptcy.
9. The obligations to disclose bankruptcy status is imposed only during the period of bankruptcy. However, with a minimum period of three years,²⁰ Australia's bankruptcy laws are more restrictive than similar countries, including the United Kingdom, which in 2004 reduced the bankruptcy period to a minimum of one year,²¹ in part to foster enterprise through 'responsible risk-taking'.²² The changes were introduced as part of the *Enterprise Act* in that country, reflecting the focus for the changes. In Australia, the short-lived experiment with early discharge has not been repeated, perhaps reflecting a different approach to facilitating entrepreneurship and a fresh start than has occurred in the UK.
10. In terms of the permanent public record of bankruptcy and other insolvency arrangements through the NPII, this has the potential to impact on employment and business start-ups, as there is currently little restriction on access to this information (as long as the prescribed fee is paid). Nor is there any restriction on how such insolvency information can be used by a potential employer, client or contractor.
11. Business start-ups and employment prospects generally are also likely to be adversely affected by various professional and occupational restrictions that are imposed on persons who have become bankrupt. In a wide range of occupations, persons who have previously been bankrupt are prevented from participating, either during the period of bankruptcy or for a period

¹⁷ *Bankruptcy Act 1966* (Cth), s269(1)(a) – ab).

¹⁸ *Bankruptcy Act 1966* (Cth), s269(1)(b).

¹⁹ Australian Financial Security Authority, *Provisional business and non-business personal insolvency time series December 2014 update*.

²⁰ *Bankruptcy Act 1966* (Cth), s149.

²¹ *Insolvency Act 1986* UK, s279.

²² See discussion in Adrian Walters, 'Personal insolvency law after the Enterprise Act: an appraisal', 2004 (available from researchgate.net).

extending beyond the bankruptcy. Occupational sectors affected by restrictions including various building trades; property, stock and business agents; the mining sector; the racing sector; valuers; security agents; and motor trades, as well as accountants, taxation agency, insolvency professionals and others. In some cases, there is a mandatory exclusion. In other cases, there is a discretion available to the decision maker (if, for example, the person had taken steps to avoid the bankruptcy). And in other cases, a previous bankruptcy is one of the factors that can be considered in determining whether the person is 'a fit and proper person'. There is considerable variations in these occupational restrictions, and where the occupation is regulated at the State/Territory level, there is also variations even within a particular occupation. In addition, there is considerable variation in the extent to which other insolvency administrations (debt agreements, personal insolvency agreements) are also associated with occupational restrictions.

12. Finding information about the applicable restrictions is no easy task; AFSA's website provides a list of some of the occupations potentially affected by bankruptcy or other insolvency administrations, but notes that "It is important to note that this is not a comprehensive listing and you are encouraged to contact the relevant licensing authority or professional body to obtain further information."²³
13. All of these sanctions and restrictions potentially act as a barrier to employment, to the 'fresh start' that is a goal of bankruptcy, and to business continuations and start-ups. Australia's minimum bankruptcy is long compared to other similar jurisdictions, and is unlikely to assist in encouraging entrepreneurship. The impact of bankruptcy (and other insolvency administrations) on employment and business is not easily identifiable, and work is needed to identify a coherent and consistent policy objective for imposing occupational restrictions upon current and former bankrupts. We do not suggest that these restrictions should necessarily be removed or reduced; but rather a detailed analysis needs to be made of the rationale for restrictions, and the appropriate length, so as to ensure that there is the scope for consistent and rational decision making in this area, as well as greater certainty for individuals considering their insolvency options.

31. Are the insolvency arrangements able to transfer assets and capital effectively? Are insolvency procedures timely to ensure assets do not become 'stranded' and unable to be used elsewhere?

14. We submit that it is questionable whether the current insolvency laws allow for the identification of the business that is to be saved through a legislative corporate rescue regime? Business textbooks²⁴ do identify the economic/business factors to look for but are they able to be incorporated into our legal rules? Generally speaking they are not. In our system we leave this largely to the professional expertise of the voluntary administrator. There is anecdotal evidence perhaps that the focus of the rescue regime, operating as it does in the shadow of liquidation, places too much focus on the legal responsibilities of directors and not enough on business conditions. The ability to rescue is often dependent upon the appointment at the

²³ <https://www.afsa.gov.au/debtors/bankruptcy/bankruptcy-overview/employment-income-contributions>

²⁴ See for example Platt, H 2004, *Principles of Corporate Renewal* (2nd ed) University of Michigan Press, Ann Arbor.

correct time. The key issue is what are the barriers to the appointment of an administrator at an early enough stage to allow the business issues to be dealt with? In this respect examination of the insolvent trading prohibitions, the Australian Taxation Office powers and practice in collecting its debts, the independence obligations of insolvency practitioners and the voluntary administration process all need to be looked at in a holistic manner. There may be other matters as well which are factors influencing the ability to transfer assets and capital effectively. This is why a broad based examination of the insolvency laws needs to be undertaken if we are to move forward.

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?*

15. On the issue of costs fundamentally we have (as with so many other areas around insolvency) no adequate data to make an informed judgement. One of the few pieces of credible information in this respect is research by Mark Wellard which has produced data showing that for small companies in his data set undertaking Deeds of Company Arrangement (DOCA), the median remuneration was \$31,500 for both the period of the voluntary administration and the DOCA.²⁵ As an absolute set of figures it does not suggest outrageous overcharging. This is however a relatively small sample²⁶ and is confined to small companies. What might be asked though is whether it is excessive? The answer to that must be that we do not know because we have no alternative with which we can make a comparison. The conditions under which each business is placed in its insolvency procedure are unique and we cannot compare it to what might have been the cost if they had operated under some other legislative regime. If it is desired to make some comparison with overseas jurisdictions then we do need to consider a large number of factors. We might also keep in mind the comment by Lubben²⁷ that:

The professional fees are the cost of moving to [a] higher recovery. The notion that money paid to professionals belongs to creditors is true only if the creditors could realize that value without the professionals.

Thus the real question is not what the costs are in absolute terms but whether they are value for money in the sense that they add to the return achieved. Again it is very difficult to know what the relevant costs vis-à-vis the returns to creditors are because we have no real data.

33. *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? Are there any barriers to innovation by insolvency practitioners?*

16. Regarding the regulation of insolvency practitioners and the potential barriers, there is substantial room for innovation in thinking about ways of dealing with dissatisfaction. We recommend recent research by members of our Centre applying audit expectation gap theory to

²⁵ Wellard M, 'A Review of Deeds of Company Arrangement' (2014) 26 (2) *Australian Insolvency Journal* 12 at 14.

²⁶ This involved 41 DOCAs classed as "small" for which data could be obtained for both the voluntary administration period and the DOCA period.

²⁷ Lubben S, 'What we "know" about Chapter 11 cost is wrong' (2012) 17 *Fordham Journal of Corporate & Financial Law* 141 at 144.

the insolvency context as relevant to evaluating the regulation of the insolvency profession and whether the current settings are appropriate.²⁸ Once again, these questions can be raised as part of a comprehensive review of the personal and corporate insolvency regimes.

42. *Should governments provide incentives, such as grants, through the tax system and insolvency arrangements, to increase the willingness of individuals and businesses to take on risk and innovate?*

17. Taxation considerations are relevant when considering the effectiveness of Australia's personal and corporate insolvency regimes. Taxation legislation impacts in numerous ways on the effective operation of insolvency laws generally.²⁹ It may well be that we can offer more by way of incentive for innovation by improving the insolvency regime than by offering some tax incentives. The US has a culture of recognising failed business entities as the opportunity to start again. No doubt our economy may well benefit from such a culture change but whether that could be obtained by changing the law is open to debate. Certainly we might look to the power granted to major creditors –such as the banks and ironically the ATO - in insolvencies and ask if we reduce that within our laws might we assist in the development of an entrepreneurial culture. Again however any change needs to be well thought through after a more comprehensive consideration along the lines of the *Harmer Report*.

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²⁸ Anderson, C and Brown, C, 'Mind the insolvency gap: Lessons to be learned from audit expectations gap theory' (2014) 22 *Insolvency Law Journal* 178.

²⁹ See for example, Brown C, Anderson C, Morrison D, 'The certainty of tax in insolvency: Where does the ATO fit?' (2011) 19(2) *Insolvency Law Journal* 108.