The importance of the insolvency industry in the Australian financial system

An extremely important part of the Australian financial system is the insolvency industry.

When a company is placed into liquidation, administration or receivership, it affects not only the shareholders, employees and direct creditors. It also often has a substantial effect on taxation collections. Also, in a substantial debtor of the trading company becomes insolvent, that company may, in turn, also become insolvent.

The problem in regulating the insolvency industry

There have been many enquiries and suggestions for reform to the laws on insolvency over the years.

The problem is that insolvency law is highly technical, and all changes must rely on the input of experts. The experts in insolvency are primarily registered liquidators, or the lawyers who earn substantial fees from acting for liquidators. For the sake of simplicity, I will refer to insolvency practitioners as "liquidators", whether they are acting in their capacity as liquidators, administrators or receivers.

Almost every change to the insolvency laws which is more power into the hands of liquidators I can provide many examples, if required.

Money recovered by liquidators primarily pays liquidators' fees, not creditors

Companies often have secured creditors, such as banks and finance companies, who hold a mortgage or charge over company assets. They are not the creditors who need help. The victims of company liquidation are the unsecured creditors, referred to in this submission as "ordinary creditors". They are generally the employees or suppliers of the failed company.

The following table shows how many of the companies under external administration made payments to the ordinary creditors. [1]

	Estimated cents in the $ dividend to unsecured creditors				
	0	0-11c	11–20c	21–50c	51–100c
Australian Capital Territory	91	3	1	6	2
New South Wales	3,581	163	34	53	19
Northern Territory	6				
Queensland	1,264	67	14	17	11
South Australia	227	9	2	2	3
Tasmania	63	7		1	
Victoria	1,264	60	17	9	5
Western Australia	341	35	7	8	8
International	3				
Total	**7,340**	**344**	**75**	**96**	**48**

[1] Taken from figures published by ASIC in December 2010 for the year ended 30 June 2010. http://asic.gov.au/asic/asic.nsf/byheadline/Insolvency+statistics+-+Series+1+Companies+entering+external+administration?openDocument

According to the table, unsecured creditors of over 92% of the companies will receive nothing. In fact, ordinary creditors of over 99.5% of the companies will receive less than 50 cents in the dollar.

Clearly, this system is not operating in the interests of the ordinary creditors.

The winners

There are no detailed statistics available on how much liquidators earn. Some published reports about particular companies give some insight, many showing multimillion dollar payments to liquidators. There are also countless smaller liquidations, where all of the company's money and assets (other than money for secured creditors) go to the liquidator.

Where do the countless millions of dollars paid to the liquidators come from?

The losers

a. Creditors

Virtually all the money paid to liquidators comes from the companies' money, money which would otherwise go to the creditors. In other words, it is the creditors who pay the fees taken by liquidators. However, they are not the only losers.

b. Creditors of creditors

Where a company goes into liquidation, with nothing paid to creditors, this can cause unpaid creditors also to become insolvent, and end up in the hands of liquidators.

c. The taxpayer

The largest loser from Australian corporate insolvency is the Australian taxpayer.

- Payment of liquidators' fees.

The ATO is a large unsecured creditor of most companies going into liquidation. In effect, the Australian taxpayer is footing the bill for a large percentage of the fees taken by liquidators.

- Tax losses

Creditors of failed companies claim a tax deduction for their bad debts. How much more tax would be collected if the money and assets of the companies taken by the liquidators went to ordinary creditors?

- Preferences

Payments to creditors in the 6 months before the commencement of the winding up must be paid back to the liquidator, subject to certain exceptions. A large percentage of these payments collected by liquidators come from the ATO. There are no published detailed figures, but the amounts involved are many millions of dollars.

- The GEERS scheme

The General Employee Entitlements and Redundancy Scheme is a government handout to employees for unpaid entitlements from failed companies. Since its inception, it has cost the Australian government the better part of one billion dollars. If money otherwise payable to employees were not taken by liquidators, there would be huge savings to the Australian taxpayer. Again, no detailed published figures are available to calculate this loss.

- Incentives not to pay tax

The insolvency law strongly encourages company directors not to try to pay the tax owed by the company. Company directors are personally penalised for making payments of tax from a struggling company, and for trying to trade their way through financial difficulty.

The mystique of the liquidator

By law, only registered liquidators can liquidate insolvent companies[i]. Also, once you appoint a liquidator, you cannot fire them, without an expensive court case.

Why should these special rules apply to this exclusive club? Why can't any chartered accountant liquidate an insolvent company? Why can't a liquidator be fired?

The reply of the liquidators is that the system is so complex that only they have the specialised knowledge to be trusted with the job.

However, modern technology, such as the LexisNexis Practical Guidance Service makes the application of the insolvency laws readily available to any accountant or lawyer. The laws on insolvency are far simpler than the tax laws which chartered accountants deal with every day.

Every time there is a government inquiry, or a suggestion on changing the laws relating to insolvency, there is consultation with the experts. Who are these experts? In almost all cases, they are the liquidators and the lawyers who make large fees from working for the liquidators.

Liquidators' fees

Liquidators generally charge according to hourly rates set by each liquidator. The following chart shows the rates charged by a typical firm. Some charge much more.

Classification	Hourly Rate (exc GST)	Description
Partner	520.00	Registered liquidator or bankruptcy trustee. Brings his or her specialist skills to the administration or insolvency task.
Director 1	375.00	Typically CA or CPA qualified with in excess of 10 years experience on insolvency matters with a number of years at manager level. Answerable to the appointee but otherwise responsible for all aspects of an administration. Capable of controlling all aspects of an administration. May be appropriately qualified to take appointments in his/her own right.
Director 2	340.00	
Manager 1	260.00	Typically CA or CPA qualified with 6 to 8 years experience working on insolvency matters. Will have experience conducting administrations and directing a number of staff.
Manager 2	220.00	
Senior Analyst 1	200.00	Typically completed or near completion of CA or CPA qualifications with 4 to 6 years insolvency experience. Assists in planning and control of smaller matters as well as performing some more difficult tasks on larger matters.
Senior Analyst 2	185.00	
Senior Analyst 3	160.00	
Analyst 1	155.00	Typically studying towards CA or CPA qualification with 2 to 4 years insolvency experience. Works under supervision of more senior staff in performing day-to-day fieldwork.
Analyst 2	145.00	
Analyst 3	135.00	
Graduate	130.00	
Support A	130.00	Generally a person currently undertakes a university degree. Works under supervision in providing assistance on tasks involved in insolvency matters.
Support B	115.00	
Vacationer	125.00	

However, the main issue is with the number of hours recorded. In the HIH meltdown, one firm of liquidators was appointed to liquidate all of the Australian companies. Fees up until August 2005 are shown in the following table.

Company	**Liquidators' fees paid**	**Liquidators' fees unpaid**	**Total Liquidators' fees**
HIH Casualty & General Insurance Limited	$22,043,549	$885,019	$22,928,568
FAI General Insurance Co Limited	$13,869,656	$630,649	$14,500,305
CIC Insurance Limited	$4,450,097	$134,565	$4,584,662
World Marine & General Insurances Pty Limited	$204,075	$135,156	$339,231
FAI Traders Insurance Co Limited	$10,340	$24,187	$34,527
FAI Reinsurances Pty Limited	Nil	$24,274	$24,274
FAI Insurances Limited	$1,195,098	$54,925	$1,250,023
HIH Underwriting & Insurance (Australia) Pty Limited	$13,517	$40,193	$53,710
Total	**$41,786,332**	**$1,928,968**	**$43,715,300**

The total of over $43m assuming an average rate of $400.00 per hour would equal a person working for 40 hours per week for 57 years.

Suggestions for reforms

The following are some suggestions for reforms to the insolvency regime:

1. Employee entitlements

The law providing that 100% of liquidators' fees be paid before any payment of employees' entitlements[2] should be changed. Because of the GEERS scheme, most of these employee entitlements are paid by the Australian government. Why should liquidators' fees come before the rights of employees, at the expense of the taxpayer?

2. Preferences

A creditor who was paid by a company before it went into liquidation should not have to give that payment to the liquidator, unless at least the majority of that money will go to the creditors, rather than being taken for liquidators' fees.

3. Insolvent trading

If the directors allow a company to run up a debt when the company cannot pay it, they are personally liable for that debt. This is fair. However, by law[3] the liquidator has control over collecting that money from the directors. In practice, almost all of it goes to paying the liquidator's fees. Those creditors should have the right to claim directly from the directors, without the money going to the liquidator.

4. Incentives not to pay tax

The many incentives for a company not to pay tax should be removed. The most blatant is the law[4] that directors may be personally liable for PAYG paid before the company was liquidated. It means that the directors of a struggling company, which pays that tax will probably end up paying the tax personally, after the liquidator claims it back from the ATO as a preference. This should be repealed immediately. It is unreasonable to punish directors because their company paid tax.

5. Liquidators' monopoly

The law should be changed to allow insolvent companies to be liquidated by chartered accountants, who can be appointed and sacked by the directors. This will expose liquidation fees to ordinary market forces.

Tim Sommerville

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[i] S.532 of the Corporations Act

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[2] Section 556 of the Corporations Act 2001
[3] S 588M of the Corporations Act
[4] S 588FGA of the Corporations Act