JOINT SUBMISSION IN RELATION TO INSOLVENT TRADING SAFE HARBOUR OPTIONS PAPER

SUBMITTED BY:

Law Council of Australia
Insolvency Practitioners Association of Australia
Turnaround Management Association Australia

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SUBMISSION IN RESPECT OF SAFE HARBOUR OPTIONS PAPER

1 SECTION 1 – INTRODUCTION

1.1 This submission is made jointly by the Law Council of Australia, the Insolvency Practitioners Association of Australia, and the Turnaround Management Association Australia, representing the legal, accounting and business advisers whose principal area of practice is insolvency. It is intended to provide the Government with the views and experience of those professionals whose day-to-day practice and business over many years has been in addressing and dealing with the very matters canvassed in the Discussion Paper.

1.2 As major participants in insolvency and turnaround matters, the bodies represented in this joint submission wish to confirm their collective view that limited reform to insolvent trading laws to provide a restructuring safe harbour would be beneficial, and that the adoption of a modified business judgement rule defence would be the appropriate means for achieving this reform. Such a change should be seen as an improvement to, rather than a replacement of, the status quo, as it provides a framework for directors and stakeholders to lawfully pursue proper restructuring opportunities, and encourages **early** attention to be given to insolvency concerns.

1.3 The parties to this joint submission are as follows:

(a) Law Council of Australia (**LCA**).The LCA's Insolvency and Reconstruction Law Committee of its Business Law Section, which has participated in the preparation of this submission, is comprised of legal practitioners across Australia who specialise in the insolvency and restructuring field, and includes many of Australia's leading practitioners in this area.

(b) Insolvency Practitioners Association of Australia (**IPA**). The IPA is the peak professional body representing company liquidators, trustees in bankruptcy, other insolvency professionals, financiers and academics. The IPA and its members necessarily have extensive knowledge of and expertise in insolvency law, policy and practice and in the particular issues of insolvent trading which are the subject of this submission; and

(c) The Turnaround Management Association Australia (**TMA**). The TMA is a not-for-profit organisation comprising professionals practising in the field of "Turnaround Management", aimed at restoring value to struggling enterprises and avoiding terminal insolvency. The TMA's membership is made up of professionals practising in turnaround management, law, insolvency, accounting, management consulting, banking, finance and private equity.

1.4 The parties to this joint submission may wish individually to provide a supplementary written submission addressing additional matters of interest.

2 SECTION 2 – PRELIMINARY MATTERS

Importance of restructurings and informal workouts

2.1 Generally speaking, a successful restructuring or informal work-out will resolve the financial position of a company through the private agreement of key stakeholders outside of any formal insolvency process. More common among large enterprises and public companies, a restructuring will involve negotiations between the company and its bankers, bondholders and/or major investors, and can involve the injection of fresh capital from an external source. Alternatively, those negotiations may produce a moratorium on repayment of bank or bond debt pending asset sales, injection of fresh capital, or both. Successful negotiations can produce a restructured balance sheet that returns the company to a state of solvency, or otherwise eliminates the question mark over the company's solvency and may thereby preserve enterprise value, employment and the business as a going concern.

2.2 The significance of this for addressing doubtful solvency is twofold:

(a) by avoiding a formal insolvency appointment, the risks of enterprise value destruction are largely avoided or diminished. These risks are identified in paragraphs 2.3 - 2.7, and the importance of them cannot be underestimated;

(b) it is usually the case that the only losses that are experienced are at the banker/bondholder/investor level - ordinary trade creditors will generally get paid in full.[1] This outcome directly contrasts the position in a formal insolvency process where ordinary unsecured creditors rank behind secured and priority creditors and share the deficit equally (and where that deficit may be enlarged should the formal appointment result in a diminution in enterprise value).

Significance of preserving enterprise value

2.3 In a circumstance of financial distress, "enterprise value" may be defined as the value of the company's assets and businesses. Preservation of enterprise value is important for at least two reasons:

(a) it maximises the prospect that a reorganisation, whether in or outside of a formal insolvency process, will be achievable. For example, to the extent that fresh capital might be a solution (either from existing investors or from an external source), the smaller the differential between the enterprise value and company's total liabilities, the lesser the amount of additional capital that would be required to remedy the position;

[1] By way of amplification, in an informal work-out of a major corporation, it is usually the case that the claims of its financiers are so significant as a percentage of its total liabilities, that it is in their commercial interests to permit the company to continue to trade under agreed funding arrangements while a restructuring is pursued. In such cases, the business continues to operate and trade creditors are paid in the ordinary course of business during the period of restructuring.

(b) in the event that the company cannot be saved and its assets need to be sold, the higher the enterprise value, the higher the return to unsecured creditors.

2.4 Similarly, where the financial difficulties of the company can be addressed by a reconstruction of the entity's banking facilities or bondholder debt (or by a combination of that and fresh capital), preservation of enterprise value is critical. Again, the smaller the differential between assets and liabilities, the smaller the gap that the reconstruction needs to address.

2.5 For the above reasons, preservation of enterprise value must be an important public policy goal in dealing with financial distress.

2.6 It is the experience of the practitioners and industry participants represented by this joint submission that formal insolvency appointments can, and often do, cause a destruction of, or diminution in, enterprise value. This can occur (as noted in the Discussion Paper) in a number of ways, including:

(a) asset sales by an administrator, receiver or liquidator can have connotations of a "fire sale", and this can produce a lower price for those assets;

(b) the ability to hold assets for sale at a later time, perhaps when the market has improved, is more difficult in a formal insolvency administration[2];

(c) the operation of "ipso facto" clauses in commercial agreements can destroy businesses overnight, consequent upon entry into a formal insolvency process, particularly where a business has few if any hard assets, but is dependent on its contractual arrangements. One.Tel is but one example of a company that completely lost its business as a retailer of telecommunications services when its wholesale suppliers of those services relied upon ipso facto clauses to cease providing those services upon the appointment of an administrator. In our experience, the prevalence of such clauses is widespread. Where businesses are, for example, reliant upon leased premises, those leases invariably contain an ipso facto clause permitting the landlord (subject to the temporary moratorium which permits continuing occupancy during the voluntary administration period) to terminate the leases even though rent is up-to-date and there is no default under the lease;

(d) customers may shun a product or brand affected by a formal insolvency when concerned about future servicing or warranty issues. Some recent examples of funds management business have evidenced this adverse impact on 'goodwill' from such formal appointments;

(e) the costs of the insolvency process, including the costs of the appointed insolvency practitioner, and his or her lawyers, can be substantial and need to be met before creditors are paid; and

[2] The *Corporations Act* imposes certain time restrictions on the conduct of an external administration. The voluntary administration regime in Part 5.3A of the *Corporations Act* provides short timeframes for the transition of the company out of administration. Section 477(1)(a) empowers a liquidator to carry on the business of the company, but only insofar as it is necessary for the beneficial disposal or winding up of that business. Also, section 478(1) requires a liquidator to cause the company's property to be applied against its liabilities as soon as practicable after the Court order that it be wound up.

(f) the crystallisation of contingent liabilities will further reduce the return to creditors.

2.7 In circumstances where it is feasible to overcome a company's solvency difficulties by an informal work-out or a restructuring of its balance sheet, it will in most cases be important for this to occur outside of a formal insolvency process.

Solvency is often a complex issue

2.8 The Discussion Paper contains the suggestion in a number of places that a company is either "solvent" or "insolvent". It is acknowledged that chronic or "obvious" insolvency can be readily identified in some companies that have continued to trade. However, in the experience of the practitioners and participants in the insolvency process represented by this submission, the company's state of solvency is frequently not black and white. The following illustrations provide a few examples of complexities that occur in practice:

(a) when, to use the phraseology used in the Discussion Paper, a "mere temporary lack of liquidity" is weighed against the ability to sell assets in the short term, what assumptions may reasonably be made by the directors as to how quickly the assets can be sold (ie what is meant by "temporary"), and the amount that can be realised for these assets. Moreover, how ought directors address them in, say, the circumstances of the recent global financial crisis when there was a question mark over the value of assets, and real concerns about whether the assets could be sold at all;

(b) where the company has a letter of comfort from its parent that is not legally binding but which has always been supported in the past, is it reasonable for directors to assume that they are solvent if they can only meet their debts by reason of their ability to call on that letter of comfort?

(c) where a company has been trading unprofitably and has only been meeting the claims of its creditors through the financial support of its major shareholder, and where that support has always been forthcoming when called upon in the past, can the directors rely on the shareholder continuing to support the business? What is the position where the directors ask for a legally binding commitment, and the shareholder declines to provide it, but indicates that it is its present intention to continue to support the company?

(d) the Australian subsidiary of an overseas company that is in a formal insolvency process overseas is trading solvently, but its balance sheet identifies a very substantial debt owed by it to its insolvent parent which is payable on demand and which it could not meet if called upon. The parent company's liquidator refuses to give a commitment that it will not call upon the intercompany debt, but has to date not done so;

(e) a large property company's facilities with its foreign banker expire on 1 December 2010, and the bank, which is withdrawing from the Australian market, will not roll the facilities. Other banks so far approached to refinance the facilities have similarly refused even though the company can clearly demonstrate it can service the facilities. It is perhaps clear that:

(i) the company is not insolvent today (i.e. March 2010); and

(ii) the company will be insolvent on 30 November 2010 if not in receipt of a commitment to refinance.

However, when, between today's date and 30 November 2010, does this company change from being solvent to insolvent?

2.9 The above represent a few examples in practice of circumstances facing honest, diligent directors. If the directors appoint administrators they risk destroying or substantially diminishing the value of the business. If they do not call in administrators, they risk incurring personal liability for the company's debts incurred in the future, which would usually mean personal bankruptcy for the directors, if found to be liable.

Comparative analysis

2.10 The laws of other countries do not impede proper restructuring attempts by directors in the way that our insolvent trading laws do. A full comparative analysis of laws is contained in the INSOL publication "Directors in the Twilight Zone", but generally speaking, in a circumstance of doubtful solvency the laws of other countries impose an obligation on the directors to have primary regard to the interests of creditors in actions they take in consequence of the financial distress. This contrasts with Australian law where the overriding insolvent trading prohibition compels directors to place the company into administration where they cannot form the requisite view as to an expectation of solvency, even in circumstances where the interests of creditors might be better served by an informal work-out. There is no flexibility at all in the law as it presently exists.

3 SECTION 3 - INSOLVENT TRADING LAW - MAINTAIN THE STATUS QUO OR INTRODUCE A RESTRUCTURING SAFE HARBOUR?

Historical and Policy Context

3.1 The issues of principle raised in the discussion paper can be seen to engage a number of different public policy considerations, including:

(a) protecting prospective creditors from the risk of loss through extending credit to an insolvent company;

(b) protecting existing creditors and other stakeholders from the risk of loss through destruction of enterprise value that is often associated with formal insolvency appointments;

(c) protecting creditors and other stakeholders from the risk of loss through the actions of unscrupulous directors; and

(d) protecting creditors and other stakeholders from the risk of loss by circumscribing the options available to honest, capable directors in dealing with the company's financial challenges.

3.2 Questions surrounding the balance to be struck between preventing abuse and curtailing honest behaviour, and between enhancing or diminishing enterprise value, are not new. As far back as the introduction of the first modern insolvency statute, the *Bankruptcy Act 1883* in the UK, the following was said by the President of the Board of Trade on moving the second reading of the Bankruptcy Bill in the Westminster parliament:[3]

> *Every good bankruptcy law must have in view two main, and at the same time, distinct objects. First, the honest administration of bankrupt estates, with a view to the fair and speedy distribution of the assets among the creditors whose property they were; secondly, following the idea that prevention was better than cure, to do something to improve the general tone of commercial morality, to promote honest trading, and to lessen the number of failures. In other words, Parliament had to endeavour, as far as possible, to protect the salvage and also to diminish the number of wrecks.*

3.3 Other policy issues were identified in the UK Greene Committee Report in 1926, where the following observations were made:[4]

> *Many of the suggestions made to us show that the idea that fraud and lesser malpractices can be stopped by the simple expedient of a prohibition in an Act of Parliament, dies hard. Other witnesses with a view to making such malpractices impossible have advocated the imposition of statutory regulations and prohibitions calculated, not merely to put a stop to the activities of the wrongdoer, but to place quite intolerable fetters upon honest business. It is often forgotten that in dealing with a matter such as company law, which affects so closely the whole business life of the nation, a certain amount of elasticity is essential if the system is to work in practice.*
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> *Impressed by these considerations, we have refrained from recommending any important change which was not, in our view, quite clearly demanded and justified by the evidence before us. We realise that the system of limited liability leaves opportunities for abuse. Some of these we consider to be part of the price which the community has to pay for the adoption of a system so beneficial to its trade and industry. It appears to us, as a matter of general principle, most undesirable, in order to defeat an occasional wrongdoer, to impose restrictions which would seriously hamper the activities of honest men and would inevitably react upon the commerce and prosperity of the country.*

3.4 The two above passages go to the heart of the policy issues raised in the discussion paper. As observed in 1883, Parliament must endeavour "*to diminish the number of wrecks*". And as observed in 1925, the policy objective of deterring some instances of wrongdoing must be balanced with the fetters it places on "*honest business*" and the damage it can do in consequence.

3.5 In this submission, five principal policy reasons are advanced as to why there should be a safe harbour defence to insolvent trading liability. They are:

(a) the existing law, without any safe harbour, can impede or prevent proper attempts at informal workouts;

(b) the effect of the existing laws on honest, capable directors, particularly non-executive directors;

[3] Westminster Hansard, 19 March 1883, col. 817.

[4] Report of the Company Law Amendment Committee appointed by the Board of Trade on 19 February 1925.

(c) the focus of directors of a financially troubled company should primarily be (as it is everywhere else in the world) on the interests of creditors;

(d) the existing insolvent trading law limits the options available to deal with financial distress; and

(e) a safe harbour defence would promote the critically important policy objective of obliging directors to obtain **early** restructuring advice.

3.6 It is also important to bear in mind that to the extent that a refinement to the law in this area will enable some companies to be saved through a restructuring or informal workout, this will result in the protection of employment and reduce job losses.

First policy reason - The existing law, without any safe harbour, can impede or prevent proper attempts at informal workouts

3.7 No other major Western economy has laws that operate in the same manner, and with the same severity, as Australia's insolvent trading laws.[5] If there are grounds for suspecting that the company is insolvent and the director is unable to form an expectation that it is in fact solvent, the director faces personal liability for all of the company's debts incurred after that date. In almost all cases, this would mean personal bankruptcy for the director. A dishonest breach of the provision renders the directors liable to imprisonment for up to 5 years.

3.8 Faced with these consequences, honest, diligent directors will ensure that they do not breach the law. For the reasons explained earlier in this submission at paragraphs 2.8 - 2.9, the question of a company's solvency frequently is not black and white, particularly with regard to large enterprises. If the solvency of a financially distressed company is uncertain or incapable of precise determination, it follows that it may be difficult for the director to form the necessary positive expectation that the company actually is able to pay all its debts as and when they fall due. Thus, not only will honest, diligent directors of companies that are actually insolvent place them into administration, but also there will be directors who feel compelled to do the same thing where the solvency is simply brought into question, because of the absence of their ability to form their positive expectation of solvency.

3.9 Moreover, there is a lack of flexibility with the current insolvent trading law. Once the operation of the law is triggered and a director is unable to form a positive expectation that the company is solvent, the director must cease incurring debts, with the likely result that administrators are appointed. This is so even though professional advice suggests it may be in the best interests of creditors that the company explore an informal workout or restructuring. The adverse implications arising from this inflexibility can be illustrated in several ways.

3.10 There are many examples of directors citing the insolvent trading laws as a reason for the appointment of administrators where a restructuring or informal workout was available to be pursued.

3.11 One example is the Henry Walker Eltin group, where the directors, citing concerns regarding insolvent trading liability, placed the company into administration.

[5] See paragraph 2.10 of this submission and the INSOL publication, "Directors in the Twilight Zone".

Ultimately, all creditors were paid 100¢ in the dollar, and the destruction of enterprise value was experienced at the shareholder level.

3.12 In many of the recent spate of corporate failures associated with the GFC, insolvent trading concerns have been cited by directors as a significant or determining factor in their decision to appoint administrators.[6]

3.13 This is not to say that a restructuring would have been feasible in all or, for that matter, most of the matters. That is not to the point. Of significance is the fact that the option of a restructuring or informal work-out is simply not available to be pursued when directors form the view that the insolvent trading law obliges them to make a formal appointment. There are many cases like Henry Walker Eltin where the formal appointment has been considered premature. No doubt in other cases, no attention was given to the issue of a restructuring as this was simply not an option given insolvent trading concerns.

3.14 It is the experience of practitioners and participants represented by this submission that the relevance of the above observations extends to companies of a smaller size as well as large enterprises and public companies.

Second policy reason – the effect of the existing laws on honest, capable directors, particularly non-executive directors

3.15 As indicated above, insolvency is often not black and white. Faced with the severe consequences of insolvent trading, there is a high burden placed on directors when the company enters the "zone" of questionable solvency. In these circumstances, directors, particularly non-executive directors for whom their personal reputation is of paramount concern, may not wish to continue their appointment. Non-executive directors in particular have been observed to resign from a company when its solvency is brought into question. This is to the detriment of the company and its creditors as this is the very time when their skilled, objective input would be highly valuable.

Third policy reason - the focus of directors of a financially troubled company should primarily be (as it is everywhere else in the world) on the interests of creditors

3.16 As indicated in paragraph 2.10, the laws of other major Western countries universally oblige a company's directors to have primary regard to the interests of creditors where the company is of doubtful solvency. As it is the company's creditors that are the stakeholders whose interests are paramount at this point, this is an appropriate policy choice. To the extent that Australian law differs, it is suggested that our laws reflect an inappropriate policy choice.

3.17 Australian law does differ in this respect as our insolvent trading law, in practical effect, requires the directors to place a trading company that is insolvent into administration (or liquidation), even though this may immeasurably harm the company and its business, and that they are in receipt of professional advice that a restructuring was feasible and to the advantage of creditors. In such a situation, the

[6] While it is not appropriate for parties to this submission to identify those companies in this public submission, some of the parties would be pleased to provide further detail in a private meeting with Treasury officials, should this be considered helpful.

directors ought to be permitted to take proper steps to pursue a restructuring, as is the case in all other major Western economies.

3.18 This is not to say that a formal insolvency appointment is inappropriate as a general proposition. This is not the case, and an early appointment of an insolvency practitioner to the company will often, perhaps in most cases, be the appropriate course. The problem with the current law is the lack of flexibility for directors to choose the appropriate course in the particular circumstances of the company.

3.19 A safe harbour is needed to provide the necessary degree of flexibility for directors to make that choice.

Fourth policy reason - The existing insolvent trading law limits the options available to deal with financial distress

3.20 Options available to deal with financial distress and which are commonly employed in overseas jurisdictions, are limited by Australia's insolvent trading laws in at least three important respects.

3.21 First, as explained in paragraphs 3.7 - 3.14 above, the achievement of a work-out or restructuring, by private agreement between key stakeholders, is impeded.

3.22 Secondly, a common feature in overseas jurisdictions is the appointment of a Chief Restructuring Officer (**CRO**) by the company, who is a skilled professional in the field. It will be the task of the CRO to perform the following executive tasks so as to advise the company's board of directors on all aspects of the restructuring:

(a) assess the financial condition of the company;

(b) examine restructuring options;

(c) engage with key stakeholders;

(d) negotiate, on behalf of the company, the restructuring with relevant stakeholders;

(e) implement the restructuring.

3.23 In contrast to the position overseas, the appointment of CROs is a very rare occurrence in Australia. This can be seen largely as a product of our insolvent trading laws in two respects.

3.24 The first is that restructurings are less frequently attempted in Australia for the reasons set out above in paragraphs 3.7 - 3.14.

3.25 Secondly, given the professional skills and expertise brought to bear by the CRO, it is anticipated that the board of directors would largely be guided by, and proceed to implement the recommendations of, the CRO. This would likely make the CRO a "shadow director" in accordance with the *Corporations Act* definition of a "director", and would therefore render the CRO personally liable for insolvent trading liability. It is unlikely that many sensible professionals would be prepared to assume that risk.

3.26 Thus, providing a safe harbour defence to insolvent trading liability for proper restructuring attempts would, subject to one qualification, enable Australian companies to enjoy the benefits associated with the appointment of CROs. The one qualification is that a further amendment would need to be made to modify or eliminate, in a restructuring context, the extended definition of a "shadow director". It is therefore very important that legislative attention is given to the definition of "director" so that a CRO, or any other stakeholder, participating in the restructuring process is not taken to be a "shadow director" of the company.

3.27 Finally, a safe harbour to enable proper attempts at a restructuring would enable another commonly used tool overseas to be available in appropriate circumstances in Australia. This is where a formal insolvency appointment will be necessary in order to restructure a company, but it is considered desirable to resolve by negotiation with key stakeholders the material aspects of the restructure prior to the formal appointment. This can enable the formal appointment to be accompanied by the assertion that the appointment has been made in order to implement the reconstruction. This can be a critical element in preserving enterprise value. A recent example is the General Motors restructuring in the United States. The "pre-pack" approach adopted with GM enabled the bankruptcy filing to be accompanied by press reports of "GM saved" rather than "GM goes bust".

3.28 General Motors traded for many months whilst insolvent in order to enable the detailed and complex negotiations with unions, bondholders and the Government to be consummated. A fully negotiated restructure plan was then presented to the Bankruptcy Court at the commencement of the formal process and adopted. Damage to the brand was minimised. In contrast, had this occurred in Australia, Australia's insolvent trading laws would most likely have compelled the directors of General Motors to appoint administrators many months earlier, at a time when there was no agreement with the Government to recapitalise the company, and no agreement with bondholders and unions to convert substantial entitlements into equity. In short, at the time of any hypothetical formal appointment in Australia, there would have been no guarantee as to the company's future and no security to anyone buying a General Motors branded car that there would be service or warranty support in the future. The damage that would have resulted to enterprise value would have increased the amount of equity required from Government and the quantum of concessions required to be made by the unions and bondholders. It would very quickly have rendered any restructuring of the nature entered into in the US increasingly unviable. In short, a restructure of this type almost certainly could not have occurred in Australia.

3.29 The contrast between what was achieved in the US, and what would have occurred in Australia, could not be starker. It is important to record that the difference has nothing to do with the availability of "Chapter 11" procedures in the US; it is a product of Australia's insolvent trading regime.

3.30 While the General Motors example is at one end of the extreme in terms of the size and complexity of businesses, the dynamics in play are no different in principle to companies smaller in size and less complex in structure. There are many examples of pre-negotiated restructure plans of a smaller, more modest size that are being successfully effected in the UK and US. Examples in the UK are Whittard of Chelsea, Mosaic and USC.[7]

[7] It must be acknowledged that some difficult policy issues exist in this area.. The fact that some regulation may be necessary in the area should pre-negotiated restructure plans become common practice in Australia does not mean that this tool for addressing insolvency should not be available.

3.31 Denying the availability of these restructuring tools in Australia is manifestly to the disadvantage of Australian business and the Australian economy.

Fifth policy reason - A safe harbour defence would promote the policy objective of obliging directors to obtain early restructuring advice

3.32 In circumstances where the law provides relief conditioned on the director obtaining professional restructuring advice, the important policy objective of ensuring that financial distress issues are addressed early and with the benefit of professional advice would be served. This is important as early intervention would maximise the prospect of a solution being found. Equally importantly, should a restructuring not be feasible, early action by directors in seeking professional advice would nonetheless identify the need for an appropriate formal appointment at an early stage.

4 SECTION D – WHICH SAFE HARBOUR OPTION SHOULD BE ADOPTED?

4.1 There are a number of legal and practical problems and disadvantages associated with the proposed moratorium that is option three in the Discussion Paper. These include:

(a) upon the issue of the notice to creditors, all creditors who then receive a payment from the company will be obliged to disgorge that payment to a liquidator should the company enter into liquidation within a six month period, as the notification would destroy any defence to an action against them for receipt of an unfair preference. This legal impairment would also no doubt have a substantial practical impact on the preparedness of those creditors to extend further credit given that repayment of that credit would also constitute preferential payments;

(b) the issuing of the notice to creditors would likely trigger the operation of many "ipso facto" clauses, permitting commercial contracts to be terminated by reason of the issue of such notification. Even where ipso facto clauses as presently drafted would not be triggered, upon the introduction of legislation providing for such a moratorium, the ipso facto clauses of many contracts would be redrafted (as was the case when the voluntary administration regime was introduced) to incorporate such an event within the definition; and

(c) the issue of such a notification to creditors and prospective future creditors would likely substantially damage the business of the company. Existing creditors would be very keen to be paid their debt as soon as possible, exacerbating any cashflow difficulties being encountered by the company. Future creditors (or existing creditors asked to rollover their debt, or those operating on a running account basis) will likely be reluctant to extend fresh credit. Suppliers may be reluctant to supply goods except on a COD basis, placing further strains on cashflow. Moreover, customers may be reluctant to buy goods manufactured by that entity, no doubt concerned about future service or warranty issues.

4.2 These additional strains placed on the business will likely make any informal restructure more difficult, and may diminish enterprise value.

4.3 It might be argued that notification or disclosure and the transparency associated with the process is the "price" of being accorded time to trade whilst insolvent in order to effect a successful restructuring. We do not in this submission take issue with that proposition. The point made in the above paragraphs is that the "price" might be such that it simply renders the restructuring incapable of being achieved, due to the impact of the process on the company's business.

4.4 It is, however, suggested that there is a further dimension to the issue. Directors are under general law duties to the company, and will be held accountable for damage caused to the company if they act negligently. If one accepts that the following two propositions are correct, then it is considered that the moratorium proposal will not work in practice in many of the circumstances in which it is designed to operate. These two propositions are:

(a) the issue of a notification to creditors, prospective creditors and all other stakeholders will place substantial additional burdens on the cashflow of the business and carry a substantial risk of damage to its business (for the reasons set out above); and

(b) it is often the case, particularly with large enterprises and public companies in financial distress, that the question of whether they are "solvent" or "insolvent" is not black and white (as to which see paragraphs 2.8 - 2.9 above).

4.5 Any "premature" issue of an insolvency notification would leave the directors exposed to an action for any consequent damage to the business. Conversely, if they do not issue a notification, they would remain at risk, as they are today, that a court would, in the future, hold them liable for insolvent trading.

4.6 This dilemma presented by the proposed moratorium would leave honest, diligent directors in the invidious position they are in today, and arguably they would be in a worse position as availing themselves of the moratorium would potentially expose them to liability as well.

4.7 Other problems and deficiencies with the moratorium option include:

(a) the process is not properly protected against abuse, as it is unrealistic to expect that the proposed "creditor oversight" will prevent abuse. Creditors will often lack the financial resources (or the preparedness to expend further financial resources) to monitor or review the appropriateness of the moratorium. Moreover, as the directors remain in control of the business, the creditors will only receive the information that the directors are prepared to provide; and

(b) the ability to approach a court to conclude the moratorium would be illusory in many, if not most, cases. A court would, quite properly, require notification of any court proceedings to be given to all interested parties and would enable them to have sufficient time within which to consider their position and present their case. The competing arguments would largely centre on financial accounting, and this would likely involve the engagement of expert accountants to review the company's accounts and prepare reports. By the time the process was undertaken and the matter was ready for hearing, it is likely that a period of weeks, if not months, would have passed. By then considerable damage could have been done to the company, with no liability attaching to the directors as they have been trading within the safe harbour.

4.8 The practitioners and participants represented by this submission are firmly of the view that option two, with some modifications, is a far superior option to option three. The principal virtues of the modified business judgment rule are as follows:

(a) it addresses the policy concerns identified in submissions sent to Minister Bowen last year that the insolvent trading laws impede proper restructuring attempts;

(b) it directly addresses the identified policy issue and does not create wider issues and implications or employ an untried and untested structure that may produce unintended or unforeseen consequences;

(c) the risk of abuse by dishonest or negligent directors is carefully addressed by the imposition of a number of objective criteria that need to be established in order to make out the defence; and

(d) it is more closely aligned with the legal position in other comparable legal systems.

4.9 Set out in section 5 below are submissions in relation to the various elements of the business judgment rule that are identified in paragraph 5.3.4 of the Discussion Paper, and the modifications to that rule that are proposed in paragraph 5.3.6 of the Discussion Paper.

5 SECTION 5 – HOW SHOULD THE BUSINESS JUDGEMENT RULE BE FORMULATED?

"Make a business judgement in good faith for a proper purpose"

5.1 This aspect of the test is considered appropriate and not in need of modification.

"In respect of a matter in which they do not have a material personal interest"

5.2 This element is perhaps problematic and in need of revision.

5.3 What is a "material personal interest"? Executive directors will be employees of the company. Many will be shareholders. They may also be creditors on director loan accounts. If the restructuring proposal involves an injection of fresh capital, the source of that additional capital may be one of the directors or interests associated with that director.

5.4 It is considered that none of the above circumstances should disentitle the relevant director from relying upon the defence. Some of the circumstances may well have implications for the participation of the relevant director in the decision of the company whether to agree to a restructuring proposal that involves the director or interests associated with him or her as a counterparty. However, the director should not be precluded from relying upon the defence to resist an insolvent trading action.

5.5 Accordingly, this requirement should either be deleted, or should be subject to the proviso that none of the above circumstances constitutes a "material personal interest" for the purposes of the application of the rule to this defence to insolvent trading.

"After informing themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate"

5.6 This aspect of the test is considered appropriate and not in need of modification.

"Rationally believe that the judgement was in the best interests of the corporation"

5.7 This aspect of the test is considered appropriate and not in need of modification.

"The financial accounts and records of the company presented a true and fair picture of the company's financial circumstances at the time that the rule was invoked"

5.8 The essence of this element, read together with the next element of the proposed rule, is (or should be) aimed at ensuring that directors and their restructuring advisers rely on accurate and relevant information, so that the directors will be in a position to form a view, with appropriate advice, on whether it is feasible that the company will remain solvent or be returned to solvency in a reasonable period of time.

5.9 The element as currently worded is considered problematic and in need of revision for a number of reasons, including:

(a) the test is essentially an audit test which has more of an historical or "backward looking" focus. In a restructuring, it is the position of the company moving forward that is most critical. While there is no doubt that accurate financial information will assist directors and professional advisers to assess the company's restructuring prospects, forward looking financial information such as cashflow forecasts (including detail as to assumptions) will be just as important, and often more important, than the balance sheet position of the company. In this regard, we note that the test of solvency for a company has been described in case law as a forward looking cashflow test (ability to pay debts as and when they fall due for payment), rather than a mere balance sheet test (assets less liabilities);

(b) if the financial accounts and records do not present a true and fair picture, the defence will not be available. This will mean that non-executive directors (and executive directors not directly involved in the financial management of the company) will not be able to avail themselves of the defence if the accounts presented to them by management turn out to be inaccurate. They have no effective control over this. Indeed, non-executive directors would simply have to take on trust that the detailed financial accounts provided to them on a regular basis are accurate, being a matter they are not in a position to ascertain, particularly with large enterprises and complex corporate groups. This is a substantial deficiency with the proposed test, as one of the policy objectives of option two is to ensure that non-executive directors, and other honest, diligent directors, do not feel unable to continue their directorships simply because of the risk posed by the insolvent trading laws. To achieve this objective it is critical to ensure that the "safe harbour" is sufficiently safe. If directors are concerned about the quality of their financial accounts or are concerned about having to establish the fact that the statements are in fact accurate (when this may not reasonably be within the directors' knowledge or control), they may not be prepared to risk relying on the rule;

(c) as the National Safety Council case demonstrates, the directors may ascertain that there has been a fraud, or that the accounts are, through no fault of some (or all) of them, inaccurate. Just because the accounts are inaccurate does not mean that a restructuring or informal work-out may not be the appropriate course, so as to serve the best interests of creditors and other stakeholders. This element of the test, however, would prevent directors relying on the business judgement defence simply because of the inaccuracy in the accounts;

(d) as the test presently stands, an inaccuracy in the accounting treatment of goodwill would mean that the restructuring defence would not be available, even though this item in the accounts would have no material impact on any restructuring;

(e) should the business judgement of the director be litigated, depending on the final form of the rule, the onus may be on the director to prove that the accounts met the requisite standard and were accurate. Establishing this point will likely involve considerable time and expense if the issue were ever litigated, and is inherently problematic given that most accounts contain some subjective analysis; and

(f) Part 2M *Corporations Act 2001* already imposes sufficient requirements on a company and its directors with regard to financial reporting.

5.10 It is suggested that this element of the test be recast in the following respects:

(a) The focus on the objective accuracy of the accounts should be replaced with a focus on the director having taken all appropriate steps to ensure their material accuracy;

(b) The focus on "true and fair picture of the company's financial circumstances" should be recast to focus on the financial information of the company necessary for the provision of restructuring advice. (This revised test should not be expressed in more specific language because different financial reports may well be relevant to different restructurings. A focus on cashflow issues may be relevant in one set of circumstances; conversely where the focus is on restructuring a company's balance sheet liabilities, the accuracy of tangible balance sheet items will be more relevant.); and

(c) Should relevant accounts be inaccurate, this should not prevent a restructuring per se, and directors should be permitted to proceed, where otherwise appropriate, with a restructuring provided they diligently remedy the deficiencies in the accounts. (Existing *Corporations Act* provisions require accounts to be accurate, and it is not being suggested that these provisions be changed.)

5.11 Raised for consideration is a replacement test along the following lines:

The director has taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed.

"The director was informed by restructuring advice from an appropriately experienced and qualified professional with access to those accounts and records, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time"

5.12 Six observations are offered in relation to this requirement.

5.13 The first is that this aspect of the test must accommodate the appointment by the company of appropriate personnel with specialist skills, such as a chief restructuring officer (**CRO**). The CRO would be an employee of or contractor with the company, whose role would be to investigate, advise, negotiate and oversee the implementation of the restructuring. The CRO would report to the board. As presently drafted, the provision would not appear to preclude the company from retaining such a professional, nor the directors from being able to rely upon that engagement, and to take account of the advice provided by him or her, in order to satisfy this aspect of the defence. These observations are therefore being made so that if any refinement or amendment to the provision is proposed, the approach should not alter the ability of the directors to perform their duties in this manner, as is commonly the case in overseas jurisdictions.

5.14 Secondly, if the restructuring advice is obtained from an external source (as, it may be apprehended, will more commonly be the case), it is considered important that the external professional be engaged by, and owe his or her duties to, the company, and not the directors. One safeguard against abuse of the safe harbour is that the directors not be able to rely on practitioners who may be sought out and engaged not for their professional skills, but for their preparedness to provide unrealistic or inappropriate advice tailored exclusively to enable the directors to continue to trade with the benefit of this defence. (It is not being suggested that this is currently occurring, only that it would be prudent to ensure that any legislative amendment does not create the opportunity for such conduct to occur in the future). By ensuring that the engagement is by the company, the professional advisers will owe their duty of care and diligence to the company, and be accountable should they fail to properly discharge their duty.

5.15 Thirdly, attention is again drawn to the shadow director concerns raised in paragraphs 3.25 - 3.26 and the need for additional legislative reform to deal with them. The legislative amendments should not have the unintended consequence of making any such adviser to the company a shadow director.

5.16 Fourthly, consideration should be given to some guidance being issued as to the required level of experience, independence and qualifications so as to assist directors in choosing a professional who will satisfy the requirement so that they may avail themselves of the protection of the rule. For example, some guidance could be provided by ASIC as to what constitutes "an appropriately experienced and qualified professional" across a range of circumstances (for example, in small businesses, SME, listed and unlisted entities).

5.17 Fifthly, it is noted that the Discussion Paper raises a concern that this element does not impose any requirement that the advice received be reasonable. We suggest that this concern poses no threat in practice as the advice must be from an appropriately experienced and qualified professional.

5.18 Sixthly, if the reference in the preceding section changes from "financial accounts and records" to "financial information", a corresponding change needs to be made to this provision.

5.19 It is therefore suggested that:

(a) the words "engaged or employed by company" be inserted between "professional" and "with access to"; and

(b) the words "those accounts and records" be replaced with "that financial information".

"It was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring"

5.20 It is understood that this element is intended to direct the attention of the directors to taking account of the interests of the company's body of creditors as a whole, given that the company is of questionable solvency (in addition to ordinary duties of directors to have regard to the interests of members of the company). If so, then this element is supported, but it will need to be carefully drafted so that it is not interpreted as suggesting that the interests of creditors are to be weighed against the interests of members.

5.21 It should also be made clear that the introduction of a modified business judgement rule defence in the context of insolvent trading will not in any way affect the existing statutory and general law duties imposed on directors.

5.22 One consideration raised in the Discussion Paper is the often divergent interests of secured versus unsecured creditors and current versus future creditors, and whether specific considerations need to be made for each of these groups. The interests of creditors may be different, but this is the case at all times. Accordingly, as is the position generally, directors will need to give all creditors due consideration. Accordingly, the reference to "creditors as a whole" is considered appropriate.

"The restructuring was diligently pursued by the director"

5.23 It is suggested that this aspect of the test requires minor attention. This is because it will not necessarily be the role of a director (in particular, a non-executive director of a large public company or group of companies) to be undertaking the day-to-day processes of the restructuring. It is for the director to ensure that the company is diligently pursuing the restructuring.

5.24 It is therefore suggested that this proposed element of the defence should be recast, and the following wording is suggested:

> "The director took all reasonable steps to ensure that the company diligently pursued the restructuring."

5.25 It is also suggested that diligence would almost certainly require early engagement between the company and its key stakeholders, such as its financiers, in the restructuring process. While this observation may not require legislative attention, it would nonetheless be prudent for this point to be made in the Explanatory Memorandum accompanying the amendments, should the government adopt option 2.

11 January 2013

The General Manager
Financial System Division
The Treasury
Langton Crescent
Parkes ACT 2600

Email: Safefinancialsector@treasury.gov.au

By Email

Dear Sir/Madam

Strengthening APRA's Crisis Management Powers

This submission is made by McGrathNicol, a firm of 30 partners and 320 staff including 22 registered liquidators, the majority of whom are members of the Insolvency Practitioners Association of Australia.

We welcome the opportunity to make a submission concerning the range of options set out in the Consultation Paper: Strengthening APRA's Crisis Management Powers (**Options Paper**).

It is relevant in the context of proposals presented in the Options Paper to note that Murray Smith, one of our partners, acted as judicial manager (and now liquidator) of the general insurers Australian Family Assurance Limited and ACN 000 007 492 (formerly Rural & General Insurance Limited), which are the only two occasions that the Court has appointed a judicial manager to general insurers on APRA's application.

Our comments are set out in the attachment to this letter and relate to chapters 1, 4, 5 and 6 of the Options Paper. Our comments address aspects of the Options Paper where we wish to point out practical implications, or concerns regarding the effectiveness of the proposals, or the manner in which they may be implemented.

As discussed between a representative of Treasury and Gary Busby of McGrathNicol, we have been provided with an extension until 11 January 2013 to finalise this submission.

If you have any queries in relation to our comments, please contact Gary Busby (02 9338 2609) or Murray Smith (02 9338 2660).

Yours faithfully

McGrathNicol
Contact: Murray Smith

Enclosure(s):
Comments on specific chapters of the Options Paper

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Strengthening APRA's Crisis Management Powers

McGrathNicol Comments on Specific Chapters of the Options Paper

Glossary

2010 Act	*Financial Sector Legislation Amendment (Prudential Refinements and Other Measures) Act 2010*
ADI	Authorised deposit taking institute
APRA	(the) Australian Prudential Regulation Authority
ASIC	(the) Australian Securities and Investment commission
ATO	(the) Australian Taxation Office
Banking Act	*Banking Act 1959*
Business Transfer Act	*Financial Sector (Business Transfer and Group Restructure) Act 1999*
Corporations Act	*Corporations Act 2001*
DOCA	Deed of company arrangement
FCS	Financial Claims Scheme
Industry Acts	Refers collectively to the *Banking Act 1959*, *Insurance Act 1973* and *Life Insurance Act 1995* but does not include the *Superannuation Industry (Supervision) Act 1993*
Insurance Act	*Insurance Act 1973*
JM	Judicial manager
Life Insurance Act	*Life Insurance Act 1995*
NOHC	Non-operating holding company. This is a holding company that does not carry on a business, other than a business consisting of the ownership or control of other bodies corporate. In this paper, NOHC will generally refer to a holding company with an ADI and/or insurer as a subsidiary.
Options Paper	The consultation paper titled "*Strengthening APRA's Crisis Management Powers*" dated September 2012
SM	Statutory manager

Strengthening APRA's Crisis Management Powers

McGrathNicol Comments on Specific Chapters of the Options Paper

1 Effective resolution of groups

1.1 Broadening the scope for the resolution of groups

In principle, we support broadening the scope for the resolution of financial groups by increasing APRA's powers to intervene effectively in the event of a crisis where it may be necessary to maintain the cooperation of non-regulated members of the group to ensure the best outcome for depositors and policyholders.

1.1.1 Proposal for control over non-regulated entities in a group

Discussion questions

(a) ***Are there other options to ensure that APRA has adequate power to resolve distress within groups, especially where a subsidiary provides essential services to a regulated entity?***

The Options Paper identifies the following four options for dealing with the control over non-regulated entities in a group:

A Enable an SM (in the case of an ADI) or JM (in the case of insurers) to be appointed to an authorised NOHC and the subsidiaries of an authorised NOHC and of a regulated entity.

B Amend the Corporations Act to provide that any liquidator or receiver appointed over a subsidiary or NOHC must cooperate with APRA.

C Enhance and strengthen APRA's direction making powers over NOHCs and related entities – including in a receivership or liquidation situation. This option can be viewed as a supplement to the above options, as opposed to being an alternative.

D A combination of Option A to C above.

Whilst other options might exist, on the assumption that time is of the essence in any process to resolve distress in a group that includes an APRA-regulated entity and subject to our comments below, we consider the options set out in the Options Paper provide the most likely practical alternatives for dealing with non-regulated entities in a group.

The power to appoint an SM or JM and for APRA to be empowered to give directions to an NOHC or non-regulated subsidiary, should be subject to rigorous controls and only be used in extreme circumstances when all other alternatives have been exhausted.

(b) ***Would there be any unintended consequences of enabling APRA to appoint or seek to appoint an SM or JM to an authorised NOHC and subsidiary?***

The non-regulated subsidiary or the NOHC may have different stakeholders to the regulated entity. In such circumstances, the interests of the non-regulated subsidiary or the NOHC and the regulated entity are likely to be different. In particular, this is likely to be the case if the non-regulated subsidiary or the NOHC is insolvent.

It is therefore important to ensure that the stakeholders of the non-regulated subsidiary or the NOHC are not prejudiced as a result of an appointment or subsequent actions of an SM or JM.

The Options Paper recognises that the proposed powers do affect some existing creditor rights (eg, it would pre-empt the rights to appoint a receiver or liquidator), and that any changes should incorporate appropriate limitations on the powers and safeguards against their potential abuse. In particular, it mentions that any actions taken by the SM or JM would need to consider fair value.

Further details are required about how fair value would be determined and how long the assessment process would take. Insufficient compensation and/or unreasonable delay may prejudice creditors of the NOHC or non-regulated subsidiary.

Consideration should therefore be given as to how these matters are to be assessed and compensated (if applicable), so that stakeholders of the non-regulated subsidiary or the NOHC know how they will be dealt with in such an event.

(c) ***What would be the implications of APRA being empowered to give directions to a subsidiary of a regulated entity or of an authorised NOHC?***

The Options Paper recognises that the board of an NOHC or non-regulated subsidiary, or (if appointed) a receiver or liquidator of an NOHC or non-regulated subsidiary, may have different priorities to APRA.

If APRA were to be empowered to give directions to a subsidiary of a regulated entity or of an authorised NOHC, it should be on the basis that such directions do not prejudice the stakeholders in the NOHC or non-regulated subsidiary.

As with the proposal to extend statutory or judicial management to authorised NOHCs and subsidiaries (see 1.1.1(b) above), the Options Paper recognises that certain protections need to be built into the proposal to extend direction powers to subsidiaries and NOHCs. In particular, there is mention of including the explicit provision that no shareholder or creditor may be left worse off than they would have been if the entity had been liquidated and that no services or functions may be required to be taken on other than just terms.

It is unclear how (and by whom) an assessment is to be made as to whether a shareholder or creditor has been left worse off than they would have been if the entity had been liquidated, or that the value of services or functions provided has been on just terms.

In addition, consideration needs to be given where the NOHC or non-regulated subsidiary may have a funding requirement to enable compliance with directions from APRA. How would such funding requirements be determined and who would be responsible for procuring the required finance?

Consideration should be given as to how such issues are to be addressed, so that the non-regulated subsidiary or the NOHC and their respective stakeholders know how they will be dealt with in such an event.

(d) ***If an entity is in receivership or liquidation, should any power for APRA to give directions to subsidiaries be limited to defined instances, such as to the giving of directions to continue to provide essential services to the distressed entity for fair value?***

In principle, we do not consider that an appointment of a receiver or liquidator to a non-regulated subsidiary should require any specific limitation in any power that APRA might obtain to give directions to a non-regulated subsidiary (see comments at 1.1.1(c) above).

We reiterate our comments at 1.1.1(c) above regarding the importance of ensuring that stakeholders in the non-regulated subsidiary or the NOHC know how they will be dealt with in the event that they have been left worse off than they would have been if the entity had been liquidated. This would include any loss suffered as a result of directed services or functions being provided on less than just terms (including the receiver's or liquidator's reasonable costs associated with the service or function).

It is also important to note that a receiver or liquidator would need to know how any funding requirement to enable compliance with directions from APRA would be dealt with.

(e) ***Would a combination of Options A and C (or other combinations) provide a more flexible tool for resolving financial distress in groups, such that the ability for APRA to give directions to subsidiaries might reduce (but not necessarily eliminate) the need to appoint a statutory or judicial manager to a subsidiary?***

In principle, we consider that Option D (being a combination of Options A to C) would provide a more flexible tool for resolving financial distress in groups.

We reiterate our comments at 1.1.1(b) and 1.1.1(c) above regarding the importance of ensuring that stakeholders in the non-regulated subsidiary know how they will be dealt with in the event that fair value has not been obtained or they have been left worse off than they would have been if the entity had been liquidated.

We also reiterate our comments at 1.1.1(d) above regarding the importance of ensuring that a receiver or liquidator knows how any funding requirement to enable compliance with directions from APRA would be dealt with.

These matters would need to be addressed in the drafting.

(f) ***Would any of the options discussed increase the cost of doing business?***

We consider that the options discussed above are likely to increase the cost of business to the extent that the board of an NOHC or non-regulated subsidiary, (or, if appointed, a receiver or liquidator) are likely to seek legal advice on their obligations following an appointment of an SM or JM or upon receiving directions from APRA.

In addition, in the event that a receiver or liquidator is required to keep the administration open longer than would otherwise be necessary to comply with directions from APRA, additional compliance and administrative costs are likely to be incurred.

1.1.2 Management of insurers in a crisis

In principle, we support amending the Insurance Act and Life Insurance Act to empower APRA to appoint an SM to a general or life insurer, an authorised NOHC and subsidiaries of an authorised NOHC and insurer in particular situations. Such situations would be where the insurer is large, or its distress poses a risk to the financial system or economy, or it is part of a complex financial group, or a rapid resolution response is needed.

Discussion questions

(a) ***Are there any reasons why APRA should not be empowered to appoint an SM (in addition to its existing power to apply to a Court for the appointment of a JM) to insurers (and related parties, as discussed above) in the circumstances outlined above?***

No. We consider that the proposals offer the flexibility to be able to move quickly in appropriate circumstances.

(b) ***Are the proposed limits on the power outlined above appropriate?***

Whilst the proposed grounds upon which APRA might appoint an SM to a general or life insurer, an NOHC or non-regulated subsidiary include the same grounds for applying to the Court to appoint a JM, they also include additional grounds. These include the introduction of criteria that differ to those set out in the Banking Act that apply to the appointment of an SM to an ADI. This involves situations where APRA has reasonable grounds to conclude that an insurer's financial position is "rapidly deteriorating" or its circumstances have the potential to "pose a risk to the stability of the Australian financial system, the economy, or a significant part of the economy".

We recommend that the circumstances under which this power is exercised would need to be defined more clearly.

(c) ***Are there other circumstances in which APRA should be empowered to appoint an SM to an insurer?***

No comments.

1.2 Clawback of capital transfers from regulated entities

In principle, we do not support the proposed amendment that the clawback provisions of the Corporations Act be temporarily prevented from having effect, as this would prejudice a fundamental right of recovery for creditors of the NOHC or related entity and would be inconsistent with how voidable transactions are dealt with in the normal course of a winding up.

The onus to prove a clawback claim rests with the liquidator of the NOHC or related entity. In practice, it is likely to take the liquidator a period of time to investigate the potential voidable transaction in order to determine whether there is a prima facie claim. Generally, if the liquidator determines that there is a prima facie claim, he or she is likely to seek legal advice on the merits and prospects of such a claim, before seeking recovery from the regulated entity. Depending upon the complexity of the relevant transaction(s) and/or quality of the evidence, this stage of the process could range from several weeks to many months.

If the regulated entity was to defend such a claim and Court proceedings were required to resolve the issue, assuming that the Court grants leave for the liquidator to commence proceedings, the whole process could be extended by many more months if the matter went to judgment.

The reality is that the regulated entity is unlikely to be in a position that it is obliged to compensate the NOHC or related entity as a result of a clawback claim during the early days following the appointment of an SM.

Discussion questions

(a) ***If this proposal were adopted, what safeguards and limitations should be imposed on APRA's power to temporarily limit clawback?***

We reiterate our comments at 1.2 above.

However, if the proposal was to be adopted to ensure that APRA has a guaranteed minimum period to assess the situation and provide alternative financial support to the regulated entity if necessary, we consider that the period of suspension should be limited to a maximum period (see comments at 1.2(b) below).

In addition, some form of financial compensation should be available for the NOHC or related entity for forgoing its right to pursue the clawback claim earlier. Such compensation would be subject to the claim either being agreed or settled between the parties or determined by the Court (**Resolved Amount**). The compensation could be in the form of interest payable on the Resolved Amount calculated for the period the clawback claim was suspended.

If the clawback claim was successfully defended or subsequently withdrawn, no compensation would be payable.

(b) ***For what period would it be appropriate to suspend clawback?***

We reiterate our comments at 1.2 above.

However, if the proposal was adopted to suspend clawback to ensure that APRA has a guaranteed minimum period to assess the situation and provide alternative financial support to the regulated entity if necessary, we consider that the period of suspension should be limited to no more than six months from the date of appointment of an SM.

2 Enhancing APRA's direction powers – scope and efficacy

No comments.

3 Australian branches of foreign entities

No comments.

4 Enhancing the statutory management and judicial management legislative frameworks

4.1 Appointing a statutory or judicial manager

4.1.1 Broaden the grounds for appointing a statutory manager to enable earlier appointment

In principle, we support amending section 13A of the Banking Act to broaden the grounds for appointing an SM to enable earlier appointment in appropriate circumstances.

Discussion questions

(a) ***Is it appropriate that APRA's power to appoint an SM to an ADI be expanded in the manner proposed?***

The first of the proposed expanded grounds is where there has been, or APRA has a reasonable basis to believe there will be, a material deterioration in the ADI's financial condition that could pose a risk to the ADI's depositors or to the stability of the financial system in Australia. This is similar to one of the proposed amendments to empower APRA to appoint an SM to a general or life insurer, an authorised NOHC and subsidiaries of an authorised NOHC and insurer in particular situations referred to at 1.1.2(b) above.

We recommend that the circumstances under which this power is exercised would need to be defined more clearly.

The second of the proposed amendments to expand the grounds where APRA can appoint an SM to an ADI is where the ADI has failed to comply with a direction given to it by APRA. This proposed amendment is vague and we recommend that further guidance on the specific types of directions be provided (similar to section 104 of the Insurance Act and section 230B of the Life Assurance Act).

(b) ***Are there any safeguards that should be attached to the power?***

It is very difficult to comment without seeing more detail of the criteria for the proposed expanded powers (see comments at 4.1.1(a) above).

4.1.2 Enable a statutory or judicial manager to be appointed to a regulated entity if an authorised NOHC is placed into external administration

In principle, we support amending section 13A of the Banking Act and the corresponding sections of the Insurance Act and Life Assurance Act to permit APRA to appoint an SM to the ADI, in circumstances where APRA believes that the appointment of an insolvency administrator to the authorised NOHC poses a significant threat to the operation and soundness of the ADI.

We recommend that the circumstances under which this power is exercised would need to be defined more clearly.

4.1.3 Broaden the grounds to appoint a judicial manager to an insurer

In principle, we support amending the relevant sections of the Insurance Act and Life Assurance Act to broaden the grounds where the Federal Court may make an order to appoint a JM to an insurer where it is in the interests of the policyholders of the insurer or of financial system stability in Australia.

We recommend that the circumstances under which this power is exercised would need to be defined more clearly.

4.1.4 Enable a statutory manager to be appointed to a bridge bank or bridge insurer

Discussion questions

(a) ***Is it appropriate for an SM or JM to be appointed to a bridge bank or bridge insurer?***

In principle, we support amending the Banking Act to empower APRA to appoint an SM to a bridge bank or bridge insurer in appropriate circumstances. This proposed amendment would allow APRA to move quickly to transfer the business of a financially distressed ADI or insurer without having to wait to find suitable directors and a CEO for the bridge bank or bridge insurer.

(b) ***Are there any risks associated with appointing an SM or JM to a bridge bank or bridge insurer?***

Any SM or JM should have appropriate capacity and experience to operate the bridge bank or bridge insurer and have a clear mandate in which to operate. Whilst a bridge bank or bridge insurer would be a new and solvent vehicle relieved of the financial distress of the original entity, an insolvency practitioner experienced in managing complex trading operations may be suitable for the SM or JM role, as they would have the commercial expertise and risk management skills to assume effective control at short notice.

APRA might like to give some consideration to how the relevant bridge bank or bridge insurer would be run once an SM or JM has been appointed, and what expertise would be available that was adequate for the challenges that would be faced by the SM or JM. While the ability to appoint an SM or JM might potentially be a useful power, it raises the prospect of how an SM or JM would carry out its function, and we think this needs further consideration.

4.1.5 Clarify that the appointment of a statutory/judicial manager (or a compulsory transfer of business) does not enable a party to a contract with a regulated entity to access security/collateral lodged under the contract

In principle, we support amending section 15C of the Banking Act and the equivalent provisions in the Insurance Act, Life Insurance Act and Business Transfer Act to make it clear that the mere appointment of an SM or JM, or the compulsory transfer of a business does not trigger terms in contracts entitling counterparties to realise or otherwise obtain the benefit from security or collateral lodged by regulated entities with these counterparties.

We note, however, that the benefit of such amendments is unlikely to be realised if the entity is already subject to an insolvency administration. This is because the “ipso facto” clauses found in many commercial agreements allow counterparties to terminate contracts upon a company’s entry into external administration. Therefore, if the entity has entered external administration prior to the appointment of an SM or JM, any right on the part of the counterparty to take action in realising or otherwise obtaining benefit from the security or collateral may have already been triggered.

Unless changes are made to commercial insolvency law along the lines of the existing section 15C of the Banking Act, APRA will need to ensure that any appointment of an SM or JM is made before the commencement of an insolvency administration if the value of the commercial agreements of the regulated entity is to be preserved (see our comments at 4.1.6 below).

4.1.6 Clarify the effect the appointment of a statutory manager or judicial manager has on a deed of company arrangement

We support amending the Industry Acts to make it clear that the appointment of either an SM or JM has the effect of terminating all other forms of external administration, including a deed administrator and the terms of a DOCA, to ensure that depositors and policyholders' interests are adequately protected.

We do not support empowering the Court to be able to make orders setting aside transactions entered into or payments made under the DOCA before the appointment of the SM or JM, or altering the terms of the deed itself, as this is likely to undermine the integrity of the DOCA process and create uncertainty for creditors.

It would be better for APRA to appoint an SM of JM (if considered appropriate) prior to the proposal meeting at which creditors decide on the future of the company (which may include that the company execute a DOCA). The proposal meeting is to be held within 28 to 35 business days of the commencement of administration, unless the court orders otherwise (it may, however, be adjourned but for no longer than a maximum of 45 business days, without court permission).

If APRA were to intervene at the stage prior to creditors approving a DOCA, it would avoid the issue of trying to unravel transactions or payments made in accordance with the DOCA, or trying to alter terms of the DOCA that have been agreed to by creditors.

The proposals at 5.2.3 below regarding extending legislative amendments so that APRA requires advance notification of all forms of external administration of a regulated entity may help avoid this situation altogether, by providing APRA with a final opportunity to appoint an SM or JM before a voluntary administrator is appointed.

As mentioned in our comments at 4.1.5 above, as the appointment of a voluntary administrator to a regulated entity is likely to trigger the "ipso facto" clauses that allow counterparties to terminate contracts upon a company's entry into voluntary administration, we consider that it would be preferable for APRA to intervene (if appropriate) before a voluntary administrator is appointed.

4.2 Moratorium provisions

In principle, we support the current moratorium provisions being repealed and replaced with a new, standardised set of provisions in the Industry Acts, drawing on relevant provisions in the Corporations Act and in the external administration regimes in other jurisdictions.

We feel it is important that the Court be the final arbiter in relation to moratorium issues. Providing that creditors and counterparties have a right to present their case to the Court, we consider that the proposed measures strike the right balance between the protection of depositor/policyholder interests and Australian financial system stability on the one hand, and the recognition of creditor and counterparty rights on the other.

In addition, we recommend that consideration be given to expressly including “garnishee” notices issued by the Tax Commissioner. Under section 260-5 of the *Taxation Administration Act 1953*, the Commissioner for Taxation is empowered to collect tax due by a taxpayer by giving notice to the debtors of the taxpayer that such debts are to be repaid not to the taxpayer, but instead to the Commissioner. If not protected by the moratorium, there is potential for assets of the ADI or insurer to be diverted to the ATO before the SM or JM has had an opportunity to determine and implement appropriate resolution measures. (Please refer to our comments at 4.6 below regarding recognition of the statutory and judicial management regimes by the ATO)

4.3 Powers and immunity of statutory and judicial mangers

4.3.1 Ensure that a statutory manager’s ability to manage an ADI’s business is not compromised by the priority provision in the Banking Act

In principle, we support that the Banking Act be amended to put beyond doubt that an SM is able to manage an ADI’s business in accordance with the provisions of the Banking Act without being constrained by the operation of subsection 13A(3).

4.3.2 Statutory immunity for statutory and judicial managers

In principle, we support that the immunity provisions in the Industry Acts be amended to ensure that the higher level of protection currently applicable to APRA staff and agents under the APRA Act is accorded to SMs and JMs.

4.4 Removing statutory managers

4.4.1 Enable APRA to terminate its control of an ADI or to remove a statutory manager

In principle, we support that section 13C of the Banking Act be expanded to enable APRA to terminate its control or to remove an SM where APRA is satisfied that the ADI has been restored to a sound financial condition and that APRA’s control or statutory management are no longer required; or where voluntary winding-up proceedings have been commenced.

4.4.2 Replacement of a statutory manager

In principle, we support that section 14E of the Banking Act be amended to make clear that APRA can terminate the appointment of an SM and replace that person with another SM where APRA believes this would be desirable for the purpose of satisfactorily resolving the business of the ADI in statutory management, maintaining confidence in the resolution process, protecting the interests of depositors or maintaining the stability of the financial system.

We recommend that the circumstances under which this power is exercised would need to be defined more clearly. In addition, we consider that the mechanism for replacement of a removed SM together with the associated “handover” obligations needs to be addressed in the drafting.

4.5 Obtaining information from entities under statutory or judicial management

4.5.1 Require directors to submit a report to statutory or judicial managers

In principle, we support provisions similar to section 475 of the Corporations Act being inserted into the Industry Acts to provide that directors and the secretary (including former directors and secretaries) of an ADI or insurer must submit to the SM or JM a report as to the affairs of the institution upon the appointment of an SM or JM unless the SM or JM, with APRA's approval, waives the obligation. This would include penalties for non-compliance without reasonable excuse.

4.5.2 Power to obtain information under judicial management

In principle, we support the Insurance Act and Life Insurance Act being amended so that these Acts are consistent with section 14AD of the Banking Act, to empower APRA to require, by notice, a person to provide APRA with information relating to the business of an insurer that is under judicial management.

4.6 Minor and technical amendments

In principle, we support all of the proposed amendments to the statutory and judicial management regimes set out in this section of the Options Paper.

In addition, we recommend that consideration be given to amending the relevant legislation so that the Australian Securities & Investments Commission (**ASIC**) and the Australian Taxation Office (**ATO**) are required to recognise SM and JM appointments.

Our experience has been that ASIC does not recognise the lodgement of notices concerning the appointment of a JM. Accordingly, there is nothing on the ASIC register to indicate that the institution is subject to a judicial management regime.

Our experience also reveals that the ATO does not recognise the concept of judicial management in terms of the lodgement of a company tax return and a notice of assessment. Accordingly, there is great scope for confusion and uncertainty concerning the ATO's powers to issue notices and returns when the company is in judicial management.

5 Powers in relation to winding up and external administration of regulated entities

5.1 Clarifying the winding up regime under the Industry Acts and Corporations Act

5.1.1 Clarifying provisions in the Industry Acts regarding the winding up of regulated entities

In principle, we support all of the proposed amendments to the Insurance Act and Life Insurance Act set out in this section of the Options Paper to remove the uncertainty regarding the grounds under which the Federal Court is able to make a winding up order in respect of a general insurer and life company.

5.1.2 Clarifying that voidable transactions are applicable where a winding up order has been made under an Industry Act

In principle, we support the relevant legislation being amended to ensure that the Corporations Act provisions concerning voidable transactions (in particular, the definition of "relation-back day") are applicable in a situation in which a Court has made a winding up order under the Insurance Act or Life Insurance Act.

5.1.3 Specifying the relation-back day

In principle, we support the relevant legislation being amended to recognise that where the entity was under statutory management or judicial management immediately before the order was made, the deemed commencement of winding up and relation-back day are the date of appointment of the SM or JM.

In the event that the entity was under external administration at the time of appointment of the SM or JM, we consider that the deemed commencement of winding up and relation-back day should be the commencement date of the first external administration.

5.2 Expanding the scope of the winding up and external administration provisions in the Industry Acts

5.2.1 Ensuring that APRA's existing powers in the winding up of a regulated entity extend to where a provisional liquidator is appointed to the regulated entity

In principle, we support the proposal that APRA be given standing to apply to the Court to give directions in relation to the powers of a provisional liquidator appointed to an APRA-regulated entity.

5.2.2 APRA to apply for the winding up of an ADI without the ADI having first been placed in statutory management

In principle, we support the proposal that section 14F of the Banking Act be amended to empower APRA to apply to the Court for the winding up of an ADI where APRA considers that the ADI is insolvent and could not be restored to solvency within a reasonable period, regardless of whether an SM has been first appointed to the ADI.

5.2.3 Providing APRA with notice of proposed applications for external administration

In principle, we support the proposal that the 2010 legislative amendments be extended so that the notification requirement is applicable to all forms of external administration, including those that are Court appointed.

As mentioned in our comments at 4.1.6 above, we consider it important for APRA to receive information about any prospective appointment of an external administrator to a regulated entity, or to a regulated entity's property, before the external administrator is appointed. This would allow APRA to understand the circumstances giving rise to the proposed appointment and for APRA to take appropriate and timely action if necessary.

Generally, we would anticipate that there would have been a period of engagement between APRA and the regulated entities and its advisors (including insolvency practitioners) preceding any final decision about external administration.

Discussion question

Will the proposed amendment impose any material compliance costs on regulated entities or insolvency professionals appointed to administer a regulated entity?

Depending upon the level of detail required by APRA, the actual cost of a written notification might not be material. In order to keep costs to a minimum, we would recommend that consideration be given to drafting a standard form of notice for this purpose.

5.2.4 Harmonising the Industry Acts on APRA's involvement in the external administration of regulated entities

In principle, we support the proposal to harmonise the Industry Acts by inserting provisions into the Banking Act that currently exist under the Insurance Act and Life Insurance Act, regarding APRA's rights:

+ to apply to the Court for directions on any matter arising under the winding up of the regulated entity, its authorised NOHC or non-regulated subsidiaries; and
+ to request information from the liquidator about the winding up of the regulated entity, its authorised NOHC or non-regulated subsidiaries.

Discussion question

Will the proposed amendment impose any material compliance costs on regulated entities or insolvency professionals appointed to administer a regulated entity?

Whilst we consider the proposed amendment has potential to impose material compliance costs, we believe that it is important for the industry regulator to have such rights given the potential impact on the interests of depositors or policyholders.

5.2.5 Ensuring that a judicial manager may be appointed to an insolvent insurer

In principle, we support the proposal to amend Part VB, Division 1 of the Insurance Act and Part 8, Division 1 of the Life Insurance Act to ensure that the Federal Court may appoint a JM to an insolvent insurer.

5.3 Clarifying circumstances surrounding 'courses of action' for insurers under judicial management

In principle, we support the proposal to amend the Insurance Act and Life Insurance Act so that the Court and JMs are not unduly constrained by the requirement to promote financial stability in cases where broader financial system stability is not relevant.

6 The Financial Claims Scheme

6.1 Proposed enhancements to the FCS framework for both ADIs and general insurers

6.1.1 Automatic declaration of the FCS

In principle, we support the proposal that the FCS for general insurers be activated automatically at the time that APRA applies to the Court for the winding up of an insolvent general insurer and where, at the time the application is made, the general insurer may be subject to claims that are eligible for protection under the FCS.

We are pleased to note that the Minister would retain the discretion to declare the FCS for a general insurer before the application for winding up, such as when a JM is appointed, upon the recommendation of APRA.

At present, a specific value (estimated claim deficit) is required to be determined before the FCS can be set up. It is unclear to us how the quantum of funding would be determined if the FCS is automatically triggered. Further guidance on this issue would be helpful.

6.1.2 Enabling the FCS to be used to facilitate a transfer of insurance business from a failed general insurer where this is more cost-efficient than effecting a payout to claimants

In principle, we support the proposal that the Insurance Act be amended to enable funds appropriated under an FCS declaration to be used to facilitate the transfer of policy liabilities from the failed general insurer to another general insurer willing to assume those liabilities in circumstances where APRA determines this to be feasible, cost-effective and efficient.

Discussion questions

(a) ***Is it appropriate to allow FCS funds to be used to facilitate the transfer of policy liabilities from a general insurer subject to an FCS declaration to another general insurer willing to accept the policy obligations where APRA assesses this to be feasible, cost-effective and efficient?***

Yes.

(b) ***Are there legal or practical impediments to enabling the FCS to be applied to facilitate the transfer of policy liabilities from a failed general insurer to another general insurer?***

It is important to ensure that the transferee company deals with policyholders/ claimants appropriately and in line with the FCS provisions for protected policyholders. Accordingly, appropriate policing of the management of eligible policyholders' claims may be required.

6.1.3 Enabling APRA to obtain information from third parties in relation to the FCS

In principle, we support the proposal that the Banking Act and Insurance Act be amended to enable APRA to require information from a third party where such information will facilitate FCS administration.

On occasions, we have had difficulty in obtaining information from policyholders (or their representatives) to allow FCS eligibility to be determined. We would therefore recommend that such proposed amendments expressly include the policyholders themselves and their representatives.

Discussion question

Are there practical/legal considerations or other impediments to enabling APRA to require information relating to the FCS from third parties?

We consider that there are likely to be issues around compliance costs. Third parties are likely to look to APRA to cover the reasonable costs of compliance.

In addition, there could be occasions where third parties assert a lien or a claim of legal professional privilege over documents that would provide relevant information relating to the FCS. Consideration should also be given to amending the Industry Acts to enable APRA to overcome such situations, to the extent that it is possible to achieve this through changes to the relevant Acts.

6.1.4 Ensuring certainty of payment of FCS entitlements made by APRA

In principle, we support the proposal that the Banking Act and Insurance Act be amended to require a liquidator of an ADI or general insurer that is declared to be subject to the FCS to accept as proof of debt the amounts paid under the FCS by APRA.

Discussion questions

(a) ***Are there practical/legal considerations or other impediments to making amounts relating to FCS payouts binding upon liquidators in the winding up of an ADI or general insurer in respect of which the FCS has been declared?***

We accept that amounts relating to FCS payouts made on the basis that APRA has complied with the requirements of the Banking Act and Insurance Act (as the case may be), and with any applicable contractual arrangements entered into with the liquidator, should be binding upon liquidators. Any amounts paid out under the FCS that do not meet this criterion, however, should be subject to the normal claim adjudication process, to ensure that the position of creditors generally is not prejudiced. For example, a liquidator would need to consider the admissibility for dividend purposes any ex-gratia payments approved by APRA on compassionate (or sensitivity) grounds, which might not necessarily constitute liability under the policy.

(b) ***Are other creditors of a failed ADI or general insurer adequately protected by the proposed safeguard?***

So long as any amounts claimed relating to the FCS that do not comply fully with the requirements of the Banking Act and Insurance Act (as the case may be), and with any applicable contractual arrangements entered into with the liquidator, are subject to adjudication by the liquidator, we consider that the other creditors should be adequately protected.

(c) ***Are there other safeguards that should be considered in this proposal?***

See our comments at 6.1.4(a) and 6.1.4(b) above.

6.2 Proposed enhancements specific to the ADI FCS framework

6.2.1 Enabling regulations to be prescribed for refining the definition of 'net credit balance' to suit particular circumstances

Discussion question

Is it appropriate that regulations to be made to allow APRA to determine what fees and charges are to be applied where this is not clear under the agreement under which an account is kept?

We consider it would be reasonable for APRA to determine what fees and charges are to be applied where this is not clear under the agreement under which an account is kept.

Any regulations to allow APRA to determine what fees and charges are to be applied should be accompanied by further regulation that would allow the account holder the right to appeal to the Court for a review of any such determination by APRA.

6.2.2 Enabling the suspension of FCS payments in respect of accounts that are the subject of a suspension, injunction or freezing order pending a determination that payment is appropriate

Whilst in principle we are supportive of the proposals to amend the Banking Act to enable the suspension of FCS payments in respect of particular frozen accounts, it is very difficult to comment further without seeing more detail.

6.3 Proposed enhancements specific to the general insurance FCS framework

6.3.1 Ensuring that the liquidator of a general insurer in respect of which the FCS is declared provides reasonable assistance to APRA in administering the FCS

In principle, we support the proposal that the same amendments as those mentioned in this section of the Options Paper made to the Banking Act by the 2010 Act, be made to the Insurance Act in respect of liquidators of general insurers for which the FCS has been declared.

6.3.2 Ensuring the effective payout of FCS entitlements to third party claimants of a policyholder of a failed general insurer where the policyholder is in liquidation

In principle, we support the proposal that the relevant legislation be amended to provide that amounts paid out under the FCS to an insolvent policyholder must be paid by the liquidator of the policyholder to whom they are due in priority to all payments under section 556 of the Corporations Act.

6.3.3 Enabling APRA to make interim payments to claimants under the FCS

In principle, we support the proposal that the Insurance Act be amended to provide APRA with the discretion to make interim payments under the FCS.

6.3.4 Extending the interim period of notional insurance coverage to 90 days

In principle, we support the proposal that the Insurance Act be amended to extend the interim period of notional insurance coverage to 90 days after the FCS has been activated.

Consideration may like to be given as to whether the 90-day extension should be optional at the Minister’s discretion.

Discussion question

Would the extension of the 28-day period of notional insurance coverage under the FCS to 90 days have any consequences other than those outlined above?

No comments.

6.3.5 Clarifying that APRA need not make separate decisions in relation to claim validity/quantum and claimant eligibility in every case of a claim made under the FCS

In principle, we support the proposal that the Insurance Act be amended so that APRA has a single obligation to make a decision as to whether a person is entitled to be paid under the FCS, rather than having obligations to make separate decisions as to validity/quantum and eligibility.

6.3.6 Clarifying that APRA may do various things in determining a claim under the FCS

In principle, we support the proposal that the Insurance Act be amended to clarify the kind of actions that APRA may take in the course of determining a claim under the FCS, such as engaging claims assessors, legal advisors, actuarial advisors and medical experts. We also support an entitlement for APRA to be able to prove in the winding up of an insolvent general insurer for the reasonable costs of such third party assistance, subject to the normal liquidation adjudication process.

We consider that it would also be appropriate to consider providing clarity concerning the responsibility for payment of run-off related administrative costs of the claims manager.

6.4 Minor drafting amendments to the Banking Act and Insurance Act in respect of the FCS

In principle, we support the proposal to make the minor drafting amendments to the Banking Act and Insurance Act set out in this section of the options Paper.

7 Financial market infrastructure

No comments.

8 Simplification and streamlining of Acts administered by APRA

No comments.

9 Proposals specific to Acts supervised by APRA

No comments.

10 Request for cost-benefit analysis information

No comments.

28 March 2014

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Strengthening the regulatory regime and fee structure for insolvency practitioners – consultation paper

The Australian Restructuring Insolvency & Turnaround Association is the professional body in Australia of company liquidators and bankruptcy trustees, and lawyers, financiers and others working or interested in the insolvency field.

We take the opportunity to make this submission both because the issues in Part 2 of the consultation paper are of direct relevance to issues we are considering in Australia, and because Australian law and practice was the subject of focus in the report of Professor Kempson, with whom we had detailed discussions during her inquiry.

The nature of this submission is to provide some clarification and explanation of Australian law and practice, and then to give some responses, from our perspective, to some of the questions you ask. We focus in particular on the proposal to remunerate practitioners on a commission based. We hope these comments may be of assistance to you.

Briefly, we say that while a commission based system for remuneration has the benefits of simplicity, it would necessarily have to be economically feasible, and given the nature of insolvency, this is unlikely unless the commission rate is set at a very high level.

The Australian regime

Initially, we need to explain some fundamental differences between our insolvency regimes that impact upon the remuneration issues raised and should assist you in understanding what we are saying in our submission.

Australia has two separate insolvency regimes, with the Corporations Act 2001 covering corporate insolvency and the Bankruptcy Act 1966 covering personal insolvency. We have two regulators and regulatory regimes, corporate regulated by the Australian Securities and Investments Commission (ASIC), and personal regulated by the Australian Financial Security Authority (AFSA). Practitioners are separately registered by ASIC as company liquidators, or by AFSA as trustees in bankruptcy, and many are registered as both. In the particular context of remuneration, practitioners must therefore abide by the laws and regulatory guidance in corporate, and by the laws and regulatory guidance in personal insolvency. These are not consistent, including in relation to remuneration. This bifurcation is seen to add to the cost of the overall regime, including its fees, and recommendations have been made by the Australian Productivity Commission, and others, for a closer alignment of personal and corporate insolvency laws.[1]

[1] Productivity Commission Research Report Annual Review of Regulatory Burdens on Business, Business and Consumer Services, ch 4.5, August 2010

Further, we have a government bankruptcy trustee, the Official Trustee in Bankruptcy, who administers over 80% of what are largely assetless bankruptcies. It charges on a commission basis; broadly taking the first A$4,000, and then on a percentage basis beyond that. It does not operate on a commercial basis. The government charges a fee on all bankrupt estates (currently 4.7% of gross realisations of every bankrupt estate, soon to increase to 6%), to assist with funding the role of the Official Trustee in Bankruptcy.

Private registered trustees administer the remainder of bankruptcies, which are generally the more substantial and complex, with their remuneration taken from realised assets and recovered funds in the estates. It is often the case that there are insufficient assets to fully remunerate the trustee. It is accepted therefore, that one of the factors practitioners take into account when setting their hourly rates is the level of unfunded work. Under the Bankruptcy Act, commission rates for registered trustees are available but are prescribed and set so low as not to be commercial and are not to our knowledge used.

In contrast, Australia has no government liquidator; all corporate insolvency administrations are handled by the private profession. Remuneration taken is taken from assets in the insolvent companies. It follows that there are often insufficient assets to fully remunerate the liquidator; the liquidator is obliged to undertake certain minimum tasks whether paid or not. ARITA recently funded a research study which determined that the private profession contributes A$40 million each year in unfunded work in court appointed liquidations.[2] It is also accepted therefore that one of the factors practitioners take into account when setting their hourly rates is the level of unfunded work. As to percentage rates, while the Corporations Act allows these, we are not aware of any liquidators using them.

Our ARITA Code of Professional Practice, to which Professor Kempson refers in some detail, attempts to give detailed guidance in relation to the recording and approval of remuneration by practitioners, both in personal and corporate. It attempts to give creditors more open and transparent information about the remuneration being sought, in order to allow creditors to make an informed decision. The Code is referred to and relied upon by the regulators, and by the courts. The Code, consistent with the law, gives guidance on the claiming of remuneration on a commission or fixed fee basis, or any other basis approved by creditors. By far the norm is that hourly rates are used.

ARITA also has a complaints process, which allows a creditor to make a complaint about the conduct of an ARITA member, and this may include a review of the member's remuneration.

The fact that in Australia there is no government liquidator means that there is no alternative appointee for nil or low asset administrations. In the case of voluntary liquidations, a liquidator will not generally take the appointment unless there is director or other external funding. But in the case of court appointments, official liquidators are required to accept such appointments. Based on the ARITA research study undertaken, liquidators recoup from company assets only 15% of their remuneration, resulting in A$47 million annually in unpaid remuneration. It is therefore unlikely, in Australia at least, that a percentage of realisations would be possible for such administrations as there are no to low realisations against which to apply the percentage. It would be uncommercial to expect an insolvency professional to undertake this work without having the right to draw remuneration from the limited realisations made.

[2] An analysis of Official Liquidations in Australia, Amanda Phillips, February 2013, at www.arita.com.au

Public interest work

The pricing of insolvency work in Australia, and the UK, is impacted by the fact that a proportion of insolvency work done by the practitioner is in the public interest - reporting to the regulator, investigating offences, enforcing director or bankrupt compliance. This work is required to be done whether there are funds available or not. If there are funds, the practitioner is entitled to be remunerated for it, but this work does not necessarily result in a return to creditors. Indeed it consumes funds otherwise available to creditors. This is a proper outcome given the wide range of interests that an insolvency regime is meant to serve.

In that respect, the concept of 'value for money' in relation to fees, referred to in the consultation paper,[3] has to be applied carefully. The 'value' may in fact not be a commercial return for creditors but rather may be that the directors are prosecuted, or that unlawful transactions are undone.

A submission by ASIC in a reported case that value or benefit to creditors should be a relevant factor in determining remuneration was rejected by Justice Barrett of the NSW Supreme Court in *Onefone Australia Pty Ltd v One.Tel Ltd*[4]

.... 29 A question debated before me is whether a liquidator seeking remuneration for specified activities must show that "benefit" flowed from those activities. I was taken to pronouncements said to support the proposition and pronouncements said not to support it. The debate is, to my mind, a sterile one, if the question of "benefit" is approached in some undefined evaluative sense. ...

30 The real question is whether the activities for which remuneration is claimed are within the scope of the liquidator's functions.

We agree with that statement. We further comment that a significant, and increasing, amount of work must be done by insolvency practitioners to comply with requirements imposed by government, statutory bodies and regulators, and this does not necessary balance well with the expectations of creditors seeking to recover their lost monies.

But we of course agree that a practitioner must act in a commercial sound way in administering an insolvent estate, for example in assessing whether to pay a dividend out of existing funds, or to use some or all of those funds to pursue recovery proceedings. To this extent, value for money is a relevant concept.

Creditor disengagement

Australia has the same issues of creditor disengagement as in the UK, which we understand is universal internationally. While ARITA's approach under its Code has been to give creditors information about what work was done in an administration, and for how much, we have feedback that creditors consider there is now *too much* information provided. That assumes creditors even attend the meeting, at which remuneration is to be discussed and approved, which is always at their time and expense. 'Postal voting' by creditors does assist in remuneration being approved, but this is only available in personal insolvency (although law reform has been proposed which would see it extended to corporate insolvency).

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[3] [101] –[102]

[4] [2010] NSWSC 1120

For those creditors who are engaged, there is a ready fee challenge process in personal insolvency to AFSA. There is no equivalent avenue in Australia in corporate insolvency; a creditor must apply to the court.

ARITA itself does provide a process for creditors who wish to complain about fees, however only a small percentage of complaints to ARITA concern fees, and in those instances fees are generally only one of a number of concerns raised in the complaint.

Nevertheless we appreciate the fact that creditors are generally ill-equipped to provide a monitoring role over fees.

Market

As to the market, there is some competition at play in relation to fixed fees for standard insolvency work in the SME section - that is, handling the liquidation of a company, investigating and reporting, dealing with creditors, realising available assets, and paying a dividend. The unpredictability of insolvency, as the consultation paper says, means that any work beyond that would have to be priced, and agreed by creditors, outside the fixed fee.

Risk

In Australia, and we understand in the UK, practitioners take on personal risk when they are appointed. Indeed, this underpins our voluntary administration regime, in that the voluntary administrator is personally liable for certain debts incurred, subject to right of indemnity out of the assets. We see this risk, and the need for caution and time in avoiding or managing it, is a factor in the remuneration costs of the insolvency regime.

The problem

We note that the consultation paper accepts there is a problem with the level of practitioners' fees, expressed as a market failure or otherwise. We cannot comment on this in the UK context, but from experience we do raise the question as to whether the "problem" is sufficiently identified for "action" to be taken on it, and indeed whether the problem is only related only to insolvency. We point out that knowledge imbalance between client and service provider is not peculiar to insolvency; and the question of hourly charging is one that is a live issue across many professions. It should also be emphasised that insolvency is generally accepted as requiring the attention of experienced and qualified professionals. Taking over a failed business and dealing with its problems is inherently labour intensive and difficult in most cases. Regulatory, reporting and accountability obligations are (properly) imposed. Insolvency is therefore an inherently expensive process under Australian law. ARITA is examining a more streamlined approach to certain types of insolvencies, and we are looking to UK experience in that regard, that would involve less work, but at the same time potentially less investigation and accountability.

For these and other reasons we have outlined, largely common between Australia and the UK, the issues are complex.

If we were to accept there is a problem, we in Australia suffer from a lack of statistics that would allow us to try to identify the problem. We are not aware of information here that would allow us to "cost" the corporate insolvency regime. However, in personal insolvency, AFSA does provide fee statistics that show the fees, in comparison to receipts, and dividends. These statistics are provided for the commission based remuneration of the Official Trustee, and the hourly based remuneration of registered trustees.

2012-2013[5]	Percentage of all bankruptcies	Receipts	Remuneration	Dividends	Other payments[6]
Official Trustee	80%	$34m	$7m	$12m	$15m
Registered Trustees	20%	$270m	$70m	$38m	$133m

Registered trustee remuneration therefore represents 26% of receipts; for the Official Trustee, the percentage is 20.5%. This is not significantly different considering that the Official Trustee is remunerated at what would be considered an uncommercially low percentage rate, though it is noted that there is an initial flat fee of A$4,000.

Therefore, it appears that private trustees' fees as a total may not be unreasonable when considered as a percentage of realisations and compared to the Official Trustee. However, it would be fair to suggest that by charging remuneration on an hourly basis it better ensures that the estates where more work is required appropriately pay more for that service. In comparison, a commission based system would not take account of this and may in fact result in inequity for those straightforward estates that may in fact have higher asset realisations.

Commission based fees

For the reasons we have set out in this submission, we do not think that commission based fees are feasible in the insolvency context, except in particular cases. They can been seen to offer the benefit of certainty and simplicity, however, they can also result in perceived inequitable outcomes should asset realisations prove to be higher than expected.

We consider that these features of insolvency go against commission based remuneration:

- The uncertain and often limited nature of assets in a significant number of insolvencies;
- The public interest and other such work of an insolvency practitioner, which goes far beyond that of simple asset sales;
- The significant personal liability risk assumed by insolvency practitioners;
- The high risk nature of insolvency recovery proceedings and associated litigation and that commission based remuneration may provide a disincentive for risk taking;
- The difficulty of setting one percentage rate to apply across a spectrum of very different situations, and if it is proposed that creditors determine the appropriate percentage there will be the same difficulties as what is currently suggested occur with time based remuneration;

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[5] ITSA annual report 2012-2013.

[6] These comprise government charges and other payments: see www.afsa.gov.au

- That, in reality commission based rates are rarely used, and where set by the law in Australia, are not practical or commercially viable.

They are a proper and useful basis for government insolvency work, where commercial viability is not expected or required.

Nevertheless, if commission rates were to be applied generally, or in a particular category of matters, they would need to be set at a level that serves to maintain the commercial viability of the profession. Insolvency and its practitioners perform an important public function which would otherwise need to be performed by government. In the UK, and in personal insolvency in Australia, it is accepted that the government must play a role where there is a lack of commercial viability, and therefore a lack of interest, for the private insolvency profession to be involved. That viability has to take into account the need for practitioners to be properly remunerated for what is complex and responsible work, where personal risk is assumed, the public interest functions performed, the extent of unfunded work, and the need for maintenance of expertise and capacity in the profession to meet the peaks and troughs of the insolvency market.

If you have any questions about this submission, other about the insolvency regime in Australia, please contact ARITA's Legal Director, Michael Murray, at mmurray@arita.com.au or + 61 2 9290 5700.

Yours sincerely

John Winter
CEO