Submission to the Financial System Inquiry

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Response to issues relating to:

External administration: Recycling capital to new businesses

The Inquiry has asked for submissions on the following matters:

> *The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:*
>
> - No change to current arrangements.
> - Implement the 2012 proposals to reduce the complexity and cost of external administration for SMEs.
>
> *The Inquiry seeks further information on the following area:*
>
> Is there evidence that Australia's external administration regime causes otherwise viable businesses to fail and, if so, what could be done to address this?

This submission deals with the matters relating to this point only.

1. At the outset we move to the first element of the second question[1] which we argue must be answered in the negative. However, we answer it that way not because we are certain that the corporate insolvency regimes cause otherwise viable businesses to fail but because we have no evidence on that matter. In its Interim Report the Inquiry notes:

   There is little empirical evidence that Australia's voluntary administration process is causing otherwise viable businesses to fail. The Inquiry would like stakeholders to provide any empirical evidence that supports that view.

   We suggest that it is unlikely any comprehensive Australian data would be provided to it on this matter simply because the only data presented which comes close to dealing with the issue has been undertaken by our Centre for Commercial and Property Law Centre colleague at the QUT Law School, Mark Wellard.[2] This data itself is limited.

   However, this lack of data has been continually noted in almost every Parliamentary report at least since the 1988 Australian Law Reform Commission *Report No 45, The General Insolvency Inquiry*. See also the Parliamentary Joint Committee on Corporations and

[1] That is, '*Is there evidence that Australia's external administration regime causes otherwise viable businesses to fail*'?

[2] See Wellard M, 'A Review of Deeds of Company Arrangement' (2014) 26 2 *Australian Insolvency Journal* 12.

Financial Services Report, *Corporate Insolvency Laws: A Stocktake* (2004) which identified [at 12.64] a "*paucity of contemporary systematic comparative information and empirical data on the operation of corporate insolvency laws*" and also Recommendation 58 at [12.72]. The Senate Economics References Committee in *The regulation, registration, and remuneration of insolvency practitioners in Australia: the case for a new framework* (2010) Chapter 9 notes the '*familiar theme'* of the call for better data at [9.3] – [9.7]. The conclusion on insolvency data was that the Committee '*strongly agrees*' that the lack of data needs to be "*addressed in a comprehensive way*".

Australia is very poorly served in terms of the publishing of available information that contributes to informed debate on corporate law generally and insolvency matters in particular. If the government wishes to improve our insolvency law, it must first invest in finding out, in a rigorous and informed way, how the current law operates. Until it is prepared to make such an investment and while instead it relies upon the anecdotal (often from well-meaning but ultimately inadequately informed participants and others) it cannot be sure that the insolvency regime we have provides our most effective regime.

2. The broad operation of the Australian insolvency regime is not something that can be dealt with in a brief submission of this type. The last comprehensive review of the insolvency system was the Australian Law Reform Commission *General Inquiry Report* (the Harmer Report) that was handed down in 1988. Whilst there have been aspects of our insolvency laws that have been reviewed since that time, none has been able to provide the clear and comprehensive analysis that is able to come from a more considered review. We argue that having regard to the current lack of data around the operation of our corporate insolvency regimes, the focus of this inquiry being of a much broader canvas and the time since the Harmer Report was handed down, a way forward would be to institute a broad review of our current law both personal and corporate insolvency to determine if an update or change is justified. Such a review ought to be conducted by the Australian Law Reform Commission or similar independent panel set up for the task. There is no doubt that insolvency laws impact on the broader activity in the economy and have a role to play in the Australian financial system; however we maintain that the proper place to deal with such considerations is through a more specific, detailed inquiry into their operation.

   In this context, it is noted that in 2013 Singapore conducted a holistic review of its insolvency regime[3] and on 25 August 2014 the Senior Minister of State for Law, Indranee Rajah, announced that Singapore is enacting major reforms of its insolvency laws as "Singapore tries to position itself as a regional hub for insolvency work and debt restructuring".[4]

3. Having noted above that our lack of data on the operation of our current laws in this area results in our being unable to say very much at all about our current regimes in a definitive way and that a sensible approach would be institute a broader inquiry into this area of law,

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

[4] http://www.channelnewsasia.com/news/singapore/major-reforms-of/1329144.html

we would nevertheless make some observations as follows about the types of matters raised in the Interim Report of this Inquiry.

4. The first matter raised in the Interim Report is the issue of costs. In this matter we have only the Mark Wellard data showing that for small companies in his data set undertaking Deeds of Company Arrangement (DOCA), the median remuneration was $31,500 for both the period of the voluntary administration and the DOCA.[5] As an absolute set of figures it does not suggest outrageous overcharging. This is however a relatively small sample[6] and is confined to small companies. What might be asked though is whether it is excessive? The answer to that must be that we do not know because we have no alternative with which we can make a comparison. The conditions under which these businesses operate are unique and we cannot compare it to what might have been the cost if they had operated under some other legislative regime. If it is desired to make some comparison with overseas jurisdictions then we do need to consider a large number of factors. We might also keep in mind the comment by Lubben[7] that:

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

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

5. Whatever their advantages or disadvantages, all regimes will involve a cost to be administered. It is by no means clear that a move to a Chapter 11 type system will lower costs in terms of the administration. Further it must be recognised that the Chapter 11 process in the USA operates within a certain institutional framework. In particular there is a system of Federal Courts dedicated to the supervision of the Bankruptcy process. If Australia were to move towards that system, what role would the courts have to play? If their role is increased, how is that cost to be carried? To what extent is there any appetite for the Federal government to establish a specialised court system of this type? We would suggest that the answers to these questions are that there is little interest in setting up specialised court supervision in this area. To a certain extent it is a role currently undertaken by the insolvency practitioner in our system. Those who advocate a Chapter 11 system need to explain what is meant by that term and in what manner the role played by the US Bankruptcy Court will be undertaken here.

6. The Interim Report goes on to suggest that the "current regime" is biased towards liquidation. There are possibly some ways in which this is correct. The Interim Report mentions insolvent trading prohibitions in this respect. It is not entirely clear why this prohibition might not encourage entry to a voluntary administration as much as a

[5] Wellard M, 'A review of Deeds of Company Arrangement' (2014) 26 (2) *Australian Insolvency Journal* 12 at 14.
[6] This involved 41 DOCAs classed as "small" for which data could be obtained for both the voluntary administration period and the DOCA period.
[7] Lubben S, 'What we "know" about Chapter 11 cost is wrong' (2012) 17 *Fordham Journal of Corporate & Financial Law* 141 at 144.

liquidation. However there are other reasons though why liquidation might be a more likely outcome here than in some comparable jurisdictions. First the Australian system does allow a creditor to seek the winding up of a company on the basis of insolvency, whereas this is discouraged under the American regime's legislative provisions. Secondly there are indirect influences that might encourage liquidation in that it seems that secured creditors are provided more protection in a voluntary administration than is the case under the American equivalent - at least in respect of a secured creditor whose security interest is over the whole of the company's property. In addition the debtor in possession model which is at the heart of the American system is potentially more likely to lead to a focus on rescue as opposed to the independent administrator who takes control in Australia. There are possibly other factors to consider if we make comparisons with, say, the English system where pre-pack arrangements are less actively discouraged. In addition the English wrongful trading provisions are more encouraging of workouts than the stricter insolvent trading provisions in Australia. Whilst a "bias" towards liquidation might be correct, to some extent this does not answer the more fundamental question as to what impact this has on the economy. That is, the form of the insolvency procedure is not as important as the benefits which flow to stakeholders from that process.

7. There is a complex array of factors that might impinge on the operation of the insolvency systems in a particular jurisdiction (hence the point above about the need for a broad response in terms of reviewing our current law). However in looking at the issue of rescue provisions we can consider some fundamental principles. Insolvency law allocates the losses in the event of financial failure of a business, such risk of failure being fundamental to a market economy. So a starting point is to recognise that in our system, the failure of corporations is part of how our market operates. Allowing resources to move from unprofitable ventures to profitable ones is desirable. Our legal system must provide for this in an efficient way. What of a rescue regime therefore? A liquidation process that operates must in a legal sense identify when a corporation has failed. This manner of identifying failure, if that is what it is to be called, needs to be correct in an economic sense. So a legal structure that involves some type of rescue would be justified in one of two situations:
    - If the means of identifying failure (insolvency) in a legal sense is inadequate in the sense that the identified firms are in fact salvageable in some way that makes economic sense; or
    - If the rescue regime can identify at a pre-failure (pre-insolvency) stage a business and achieve a turnaround before it becomes too late.

    This suggests that we have a connection between liquidation and business rescue. However it must also be recognised that, unlike liquidation, in a business rescue the legal rules play less of a role because fundamentally there need to be the economic conditions present to achieve the rescue whereas liquidation rules will by their very nature cause the event to happen.

8. The question then becomes do our legal rules allow for the identification of the business that is to be saved through a legislative corporate rescue regime? Business textbooks[8] do identify the economic /business factors to look for but are they able to be incorporated into our legal rules? Generally speaking they are not. In our system we leave this largely to the professional expertise of the voluntary administrator. There are perhaps in our system anecdotal evidence that the focus of the rescue regime, operating as it does in the shadow of liquidation, too much focus on legal responsibilities of directors and not enough on business conditions. The ability to rescue is often dependent upon the appointment at the correct time. The key issue is what are the barriers to the appointment of an administrator at an early enough stage to allow the business issues to be dealt with? In this respect examination of the insolvent trading prohibitions, the Australian Taxation Office powers and practice in collecting its debts, the independence obligations of insolvency practitioners and the voluntary administration process all need to be looked at in a holistic manner. There may be other matters as well which are part of the factors influencing the rescue of the business. This is why a broad based examination of the insolvency laws needs to be undertaken if we are to move forward.

9. In respect of regulatory architecture and insolvency, a merger of corporate and personal insolvency law has been considered over the years, notably in the 2004 *Corporate Insolvency Law Stocktake*.[9] While there is some merit in the external administration provisions being part of corporations legislation as a whole and therefore issues such as directors' duties, public listing etc. being framed within the whole of life of a company, there are clear benefits in a merged regulatory architecture and a combined personal and corporate insolvency regulator. It is noted that this was recommended by a Senate Committee in 2010[10] although the Australian government rejected the recommendation in 2011.[11] It is submitted that this decision warrants reconsideration, due in part to the increasing complexity in business failure and rescue, including for international businesses.

10. As a final point, we note that taxation considerations have been included in the Interim Report of this Inquiry in relation to other areas of review, for example Funding (Chapter 3) and Superannuation (Chapter 4), and suggest that the same considerations apply in relation to the effectiveness of Australia's external administration regime. That is, any review of the effectiveness of Australia's external administration, or indeed a broader review of insolvency laws, would need to be carried out in conjunction with a review of Australia's taxation regime. There are numerous ways in which the taxation legislation impacts on the effective operation of insolvency laws generally.[12] In the absence of a more holistic approach to insolvency and taxation law, any measures that are aimed at increasing the effectiveness of

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

[9] Parliamentary Joint Committee on Corporations and Financial Services 2004, *Corporate Insolvency Laws: a Stocktake*, [12.73] ff; Productivity Commission 2010, *Annual Review of Regulatory Burdens on Business: Business and Consumer Services Research Report,* p175.

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

[11] Australian Government 2011, *Options paper: a modernisation and harmonisation of the regulatory framework applying to insolvency practitioners in Australia*.

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

Australia's external administration regime may be impeded by taxation regulation that is inconsistent with the fundamental objectives of corporate rescue.

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