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26 August 2014

Mr David Murray AO
Chair
Financial System Inquiry
GPO Box 89
Sydney NSW 2001

By email to: fsi@fsi.gov.au
Uploaded via link at: http://fsi.gov.au/consultation/submissions/

Dear Sir

Re: The Financial System Inquiry 2014 Interim Report
Growth and Consolidation – Funding – External Administration

Introduction

We refer to the Financial System Inquiry's (**the Inquiry's**) invitation to provide a submission in relation to the above matter.

The aim of this paper is to provide our views on the current external administration process, and its ability to facilitate the efficient recycling of capital within the economy, compared to other options.

Ferrier Hodgson has been a leading independent firm for over 35 years, specialising in Corporate Recovery, Corporate Advisory and Forensic Accounting services. During this time, Ferrier Hodgson has undertaken all types of formal and informal engagements ranging from small bankruptcies and liquidations to complex voluntary administrations, receiverships, schemes of arrangement and informal restructurings and turnarounds. In this regard, we are in a position to offer our view on the current system from legislative, efficiency and cost perspectives.

This submission is structured to address the various discussion points and direct questions raised in the Inquiry's Interim Report. Unless otherwise indicated herein, our comments relate to Australia's corporate external administration regime rather than its personal insolvency regime.

Discussion points

1. A well-functioning external administration regime facilitates the efficient recycling of capital and so contributes to the efficiency with which funds are allocated in the economy.

In the context of Australia's external administration regime, the efficient return of capital to the economy involves maximising the value of the insolvent's assets whilst minimising the costs related to external administration and distributing the assets in a timely manner. Thus ideally, external administrations should:

1. Seek to preserve the company's business as a going concern, where possible
2. Maximise value of assets
3. Minimise costs
4. Realise and distribute assets efficiently

As discussed below, in some circumstances a trade-off between the above outcomes is required due to the complexity of the administration. However, we agree that the efficient recycling of capital is an important consideration for all external administrations.

The importance of insolvency regimes facilitating the efficient recycling of capital is highlighted in the Harmer Report[1] which provides the following 'principles' of insolvency (Para. 33):

- Insolvency law should provide mechanisms that enable both debtor and creditor to participate with the least possible delay and expense;
- An insolvency administration should be impartial, efficient and expeditious; and
- Insolvency law should, so far as it is convenient and practical, support the commercial and economic processes of the community.

The Cork Report[2], which was used as a reference point for the Harmer Report, also commented on the requirement for external administrations to return capital to the society as a whole with as 'little fuss as possible' (paras. 23-25).

It is our view that the current external administration regime does allow for the effective and efficient recycling of capital. There are various mechanisms within the regime which enable the efficient administration of all types and sizes of enterprises. These mechanisms are discussed in detail throughout this submission.

[1] Australian Law Reform Commission (ALRC), *General Insolvency Inquiry -Report No. 45 (the Harmer Report),* Australian Government Publishing Service, Canberra 1988.
[2] United Kingdom Review Committee, *Insolvency Law and Practice (the Cork Report*), Cmnd 8558. HMSO, London, 1982

There are, however, a number of changes which should be considered, which we believe would enhance the chances of success of informal or formal turnarounds. By their nature, turnarounds of businesses are likely to result in a more efficient recycling of capital than that which results from a formal external administration process. Potential changes include the introduction of a safe harbour from insolvent trading penalties for directors undertaking informal turnarounds and a moratorium on the enforcement of ipso facto clauses following an insolvency event. These suggested changes are addressed in further detail later in this submission.

2. <u>A well-functioning external administration regime also protects creditors' rights, which promotes confidence in broader credit provision.</u>

There are generally two categories of creditor: secured and unsecured.

A secured creditor is someone who has a security interest (as defined in s12 of the *Personal Property Securities Act 2009* (**the PPS Act**)), such as a charge, mortgage or a retention of title claim, over some or all of the company's assets to secure a debt owed by the company. In addition to PPS Act requirements, a creditor can be secured by way of a mortgage over land. An unsecured creditor is a creditor who does not have a security interest over the company's assets or a mortgage over land.

Through both common law and contract law principles, there are a number of different mechanisms which are designed to protect the rights of various classes of creditors. Australia's existing external administration regime provides adequate mechanisms to protect those rights and ensure that confidence in the credit system is maintained, primarily through the *Corporations Act 2001* which specifies the priorities and treatment afforded to the various classes of creditor.

The relative position and standing of each class of creditor, as well as the risk and return proposition to those transacting with a corporate entity is, by and large, very clear within the existing framework of commercial and legal principles.

The principles seek to protect or prioritise those who contribute most in terms of the financial and/or human capital required for businesses to operate. As an example, secured creditors (e.g. banks) often provide the majority of funding required by businesses to operate and grow. Accordingly, secured creditors typically rank first in terms of repayment of their debts in an insolvency scenario.

Another example of a class of priority creditors is employees. In external insolvency scenarios, outstanding employee entitlements are paid in priority to the claims of other unsecured creditors and also ahead of the circulating portion of secured creditors' debt. In recognising the critical role employees play and also that employees often have less information or control than other parties choosing to contract with a corporate entity, the priority provisions of the Corporations Act and the Federal Government's Fair

Entitlements Guarantee (**FEG**) Scheme act as an additional and appropriate layer of protection for employees. It is worth noting, however, that FEG is open to abuse by unscrupulous directors or management who can transfer assets out of the employing company which leaves the government 'picking up the tab' for employee entitlements in a liquidation. That type of asset transfer (which can be indicative of phoenix behaviour) can be investigated by a liquidator, although an issue often arises regarding who will fund such investigations.

3. <u>External administration of an entity involves costs, but it is important that these costs are minimised, so the maximum amount of capital can either be retained in a business that is able to continue operating or reallocated to more productive activities.</u>

   Total costs of an external administration include the insolvency practitioner's fees as well as other costs such as legal, marketing, sales expenses and/or the costs of continuing to trade a business as a going concern or winding down its operations. Those costs are aligned with the level of complexity and variables specific to each particular engagement. No two external administrations are exactly alike and the costs associated relate to the amount of time and work required in order to address the specific issues therein, with the aim of preserving the business as a going concern or providing the best possible outcome for creditors.

   In general terms, higher costs will usually result from large, complex administrations. For example, administrations can involve significant trading issues and work required to develop and/or assess options to preserve the business. In addition, administrations can involve legally complex disputes which require the assistance of legal teams and the input of the courts to aid in the recovery of funds and the determination of who, in fact, are the rightful creditors.

   Another example of work which can result in high costs is where, following investigation of the insolvent company's affairs, the liquidator identifies antecedent transactions such as unfair preference payments which may be recoverable, uncommercial transactions which may be set aside, or possible claims against the company's officers.

   The liquidator will incur fees and expenses in taking action to recover those further assets if the ultimate outcome will benefit creditors and such tasks can often require the assistance of legal advisers. These examples illustrate that often there is a need for insolvency practitioners to incur time and expenses in order to achieve a more favourable outcome for creditors. To that end, creditors (including via Committees of Inspection) have an important role to play in the decision-making process a liquidator undertakes in deciding which actions to pursue. Whilst the liquidator is not obliged to take into account creditors' opinions regarding the work to be undertaken, in circumstances where it is the creditors who decide whether to approve a liquidator's remuneration, those opinions need to be carefully considered. Creditors, in other words, play an important role in ascertaining what work needs to be undertaken and therefore what costs should be incurred.

It is also important to note that external administrations which can appear relatively straightforward on face value, and for which one might expect the costs of administration to be low, may actually require significant work to be undertaken by the insolvency practitioner and his/her advisers in order to maximise the recoveries for creditors, for example via the recovery of antecedent transactions. Again, the point is made that the ultimate outcome to creditors should be the determining factor of an efficiently operating external administration regime (which in turn leads to the recycling of capital into the economy), rather than costs alone.

Notwithstanding our comments above, we agree that a vital element of a well-functioning external administration regime is to ensure that unnecessary costs are avoided, whether they are general costs of the administration, insolvency practitioners' fees or disbursements to third parties. The avoidance of unnecessary costs is obviously important in order to reach an optimum efficiency trade-off, which leads to the continued operation of the business as a going concern and/or the maximum return to creditors and therefore capital to be recycled into the economy.

Under processes in the *Corporations Act* 2001 and the ARITA Code, the insolvency practitioner is entitled to remuneration for proper work done, and it is the creditors of a company who have a right to question that remuneration and approve it. If creditors do not approve the practitioner's fees, the Court can decide.

The reality is that a great deal of insolvency work is complex and labour intensive, and aside from trading or asset realisation issues, insolvency practitioners must investigate misconduct and report any offences to ASIC. Further, there are many cases where insolvent companies have few, if any, assets remaining and in those circumstances much of the work of an insolvency practitioner is unremunerated. For example, research undertaken in 2012 for ARITA by Amanda Phillips of Ferrier Hodgson showed that insolvency practitioners are required to personally fund disbursements of $1.4 million and remuneration of $47.3 million annually in relation to official liquidations alone.

Under both the ARITA Code and *Corporations Act 2001* requirements, when requesting fee approval practitioners must report to creditors providing sufficient information to enable them to make an informed assessment of whether the proposed fees are reasonable. The practitioner must summarise the major tasks performed, or tasks to be performed, and outline or estimate the costs associated with each of these tasks. Fee approval may be granted by Creditors, a committee of creditors (if appointed), or the Court.

Further, in circumstances of an appointment of administrators, under s443(a) of the Act the administrator of a company is personally liable for any debts incurred in the performance or exercise of their functions and powers as an administrator. Whilst this section is in place to encourage administrators not to act in a reckless or improper manner which may be detrimental to the interests of creditors and other stakeholders, it might also result in higher costs (i.e. if personal liability did not attach) as a consequence of the administration being conducted conservatively or protectively..

4. <u>Some submissions argue that the current regime is biased towards liquidation. They claim the prohibition on trading while insolvent, and its associated penalties, make directors more cautious in attempting to reorganise a business that could continue to be viable.</u>

The existing regime reflects government's policy of seeking a balance between protecting stakeholders and encouraging sensible commercial risk-taking, both of which require a degree of caution to be exercised by directors. The risk of and deterrents to insolvent trading, as discussed throughout this submission, are designed to encourage directors to seek professional advice in a timely manner. Appropriate advice enables directors to make balanced, prudent decisions regarding the future course of the affected business.

Part 5.3A of the *Corporations Act 2001*, introduced in June 1993, is designed to provide a flexible and cost-effective process to deal with financially distressed businesses. Its aim is to maximise value for creditors where that value might not be achieved from an immediate liquidation.

Voluntary Administration has largely replaced the more cumbersome and costly process of Schemes of Arrangement as the preferred method of restructuring insolvent companies, notwithstanding both regimes have the same objectives. Because of the timely and simple appointment procedure, Voluntary Administrations became a popular precursor to a creditors' voluntary liquidation in circumstances where no restructuring was contemplated.

Accordingly, the Voluntary Administration procedure became known by some as merely a preliminary step to liquidation, thereby detracting from its role as a restructuring tool. This was recognised in the 2007 Corporations Act reforms which simplified the entry process to liquidation, ensuring as much as possible that a Voluntary Administration would only be contemplated in circumstances where a restructure and/or sale would maximise value compared to an immediate liquidation.

Notwithstanding the legislative aims, based on ASIC's statistics regarding the number of external administration appointments, it appears that Australia's existing regime continues to result in a high proportion of companies going into liquidation. Those statistics show that between the 2000 and 2013 financial years there were 44,464 court windings up and 66,200 creditor windings up, compared to 31,079 voluntary administrations and 8,488 deeds of company arrangement. This infers that more than 70% of voluntary administrations over that period progressed into liquidation[3].

There are a number of possible reasons for this, including:

- Directors being slow to take advice and action in relation to the financial distress of their business.
- Whilst voluntary administration is generally a more costly way to proceed to a winding up than a creditors voluntary liquidation, often the outcome is unknown until the voluntary administration commences.
- Appointing a receiver/controller is not an option available to directors as only parties with a security interest over the company's assets are able to take this course of action. Moreover, Schemes of Arrangement are costly and time consuming due to the necessity to obtain both shareholder and court approval. This process can be particularly difficult and costly if creditors of the business are hostile.
- Directors are also likely to be dissuaded from attempting an informal work-out or restructure of a business due to strict insolvent trading laws under section 588G of the *Corporations Act 2001*. Section 588G requires a director of a company to prevent the company from incurring a debt if the company is already insolvent at the time the debt is incurred; or if by incurring that debt the company becomes insolvent.
- Directors who trade whilst insolvent face civil penalties, compensation proceedings and/or criminal charges, all of which can result in significant pecuniary penalties and/or imprisonment in the case of criminal charges.
- The inclusion of ipso facto clauses within most commercial contracts allows the non-defaulting party to terminate contracts in an event of the contracting party's insolvency (including the appointment of a voluntary administrator). This means that when ipso facto clauses are enacted and contracts are terminated upon the appointment of an external administrator, the value of a business' key contracts and assets may be immediately and substantially diminished, reducing the ability of the business to continue operating or to be sold as a going concern. This results in companies who have entered into voluntary administration going into liquidation rather than being operated, restructured and/or sold via a deed of company arrangement process, despite the best intentions by directors and/or administrators. We comment further on ipso facto clauses in Section 5 herein.

[3] Once a company enters into voluntary administration there are three possible options under s. 439C of the *Corporations Act 2001*: 1. A deed of company arrangement is entered into; 2. The company is liquidated; or 3. Control of the company is handed back to its directors. It is extremely rare for creditors to vote for option 3.

It is important to note, however, that statistics alone do not tell the full story. One thing that tends to get missed in discussions such as these is that many voluntary administrations are activated to bring an end to situations of insolvency and to start the process of dealing with a problem. That might result in a Deed of Company Arrangement, but more often than not that can end with the business being sold out of voluntary administration. This is then followed by the company corporate shell being liquidated.

In the situation above the liquidation will be recorded in ASIC's statistics, but not the sale of the business out of voluntary administration. In that way, the statistics are potentially skewed. Far from equating to a destruction of value, the voluntary administration process is used as a mechanism to find a partner/competitor for the failed enterprise to combine with, or facilitates an injection of equity by selling the business, which is then recapitalised via its creditors (who might, for example, agree to take a haircut on their debt where the outcome is better than in a liquidation). The outcome is that the sold business can start with a clean slate.

With reference to Australia's insolvent trading provisions, we agree they act as a deterrent to restructuring attempts by directors, but in our view those provisions require further thought as they do not fully achieve their intended purpose of protecting creditors and acting as a deterrent to reckless trading. To that end we note the insolvent trading provisions are a subjective area of the law and which has been rarely successfully prosecuted.

The insolvent trading provisions do seek to protect unsecured creditors, such that a company's management does not continue to operate where unsecured creditors are at risk of not being paid.

Provisions protecting creditors should reflect a positive obligation on directors to consider all options including informal workouts. This is so because protecting creditors primarily means preserving value such that present and future obligations are met.

Section 435A of the *Corporations Act 2001* recognises the imperative of maximising value for creditors if a voluntary administration can produce a better outcome than from an immediate liquidation. In a true sense, directors may well be constrained from acting in the creditors' best interests by the requirement to appoint a voluntary administrator when a company is insolvent or may become insolvent. The next question directors face when insolvency or impending insolvency is known should be: "What further, if anything, can be done to ensure the best outcome for creditors?" This should include consideration of an informal workout option if that is what, on balance, will produce the best outcome.

However, directors appointing an external administrator as required by the *Corporations Act 2001* when a company is insolvent or is likely to become insolvent may, in fact, be reducing enterprise value. A director, in meeting the statutory obligation to avoid insolvent trading, may breach his duty to act in the creditors' best interests when there is a viable informal workout option (recognising that, when a company enters into the zone of insolvency, the interests of creditors are elevated). That perversity is more so given a director, in appointing an administrator, may well breach his duty as a director in being primarily motivated by the desire to avoid personal liability rather than maximising value for creditors (that is, acting in self-interest), although we note a director may often be acting on professional advice.

We believe a better approach is to impose a positive obligation on directors to consider value preservation through a reorganisation without recourse to an external administration where strict criteria and requirements, set out clearly in the *Corporations Act*, are met. In our view it is important for the criteria to be documented in statute (for example via an expansion of sections 1317S and 1318 of the *Corporations Act 2001*) because it is important for unsecured creditors, including employees, to continue to be protected. The existing regime requires and enforces transparency, disciplined timeframes and honesty in dealings. Whilst there is a clear rationale for encouraging workouts and turnarounds in the right circumstances, it is important that we do not lose the protections (including transparency of process) for creditors.

If the criteria cannot be met, and the director incurs further debt, the director would be liable for insolvent trading. We acknowledge, however, that directors of SMEs are more likely to run with this option – particularly if personal assets are involved. Professional directors of publicly listed companies are likely to be less so inclined, for obvious reasons.

In terms of deterring abuse, a balance must always be managed between creditors' interests and encouraging sensible commercial risk-taking. Thus, deterrence is a major factor underlying the insolvent trading provisions.

The *Corporations Act* seeks to achieve deterrence primarily by:

- Providing liquidators with the ability to seek compensation from directors personally.
- Providing creditors, through sections 588R and 588S of the *Corporations Act 2001*, with the ability to bring their own action against directors seeking compensation.
- ASIC's ability to seek criminal prosecution of directors.

The cost of bringing an insolvent trading action, however, can often make a claim uncommercial in administrations involving SMEs. Having said that, as previously noted herein the creditors have an important role to play in providing their views (via, for example, committees of inspection) as to whether a liquidator should expend the time and cost of undertaking insolvent trading actions. Whilst not determinative, a liquidator should carefully consider the views of creditors, given it is their money which is at stake.

In larger administrations, such as those of publicly listed companies, the cost and complexity of proving insolvency means that the risk/reward equation dictates bringing a claim only in limited circumstances. Again, with the outcome to creditors at the forefront of a liquidator's thinking, this seems to be an appropriate result.

Further, in our experience, a significant number of statutory reports prepared by liquidators for ASIC include the identification of insolvent trading as a potential offence. Yet very few of these are pursued such as to send a strong deterrent message to the business community. We suspect a lack of resources/funding at ASIC leads to this outcome, which could be rectified by government.

In addition, normal asset protection strategies employed by directors and the fact that secured creditors of a company will generally hold personal guarantees from directors, means that often directors will not have the assets to pay compensation orders if they are found liable for insolvent trading.

We note ASIC's Regulatory Guide 217, *Duty to prevent insolvent trading: Guide for directors*, issued in July 2010, sets out the key principles which, if met by a director, would mean that ASIC would likely not pursue an insolvent trading action. Those principles, by and large, reflect the elements of a business judgment rule (as part of a director safe harbour) applying to insolvent trading.

Our current view is that directors would be better placed to decide whether to trade on when a company is in the zone of insolvency if the *Corporations Act* sets out the specific criteria by which a director will be judged if he/she continues to trade during the zone of insolvency. This may be achieved through the introduction of a business judgement rule for insolvent trading based upon criteria such as those contained in ASIC Regulatory Guide 217.

5. Stakeholders suggest that placing a company into voluntary administration can lead to the failure of a business that could survive with some restructuring, because voluntary administration processes can significantly devalue a company and involve significant costs.

Australia's existing voluntary administration process is relatively flexible and allows for the protection of stakeholders. In particular, a moratorium is imposed on unsecured creditors, secured creditors who fail to exercise their security within 13 days of the appointment of voluntary administrators, creditors who hold third party guarantees and landlords. The voluntary administration moratorium restricts the actions which can be initiated by affected parties immediately after the appointment of voluntary administrators and during the administration process, allowing the administrators time to assess the viability of the business continuing in some form.

In our experience, companies that enter voluntary administration are almost always already insolvent or very likely to become insolvent. To that end, section 436A of the *Corporations Act 2001* requires the directors of a company to make a resolution that, in their opinion, the company is insolvent or is likely to become insolvent, prior to the appointment of an administrator. We therefore do not support the view that businesses fail because of a voluntary administration appointment, but rather that the appointment results from the failure of the business.

Whilst statistics are not maintained, we are aware of instances in which a business might have survived with some informal restructuring – i.e. prior to external administration. We agree that the voluntary administration process can be costly (please refer to our earlier commentary regarding costs) and can also devalue a company and its assets.

One of the key factors likely to cause a diminution in value of a company and/or its assets following the appointment of a voluntary administrator is the effect of ipso facto clauses in contracts between companies and suppliers/creditors. The triggering of such clauses upon the appointment of a voluntary administrator means it is virtually impossible to then undertake a meaningful restructure or workout using the voluntary administration regime. Ipso facto clauses stipulate the consequences of the insolvency of a party to a contractual agreement[4] and primarily give the other contracting party the right to terminate a contract in the event of insolvency.

The impact and usefulness of ipso facto clauses have been considered by previous federal governments. The 2004 report of the Federal Government's Corporations and Markets Advisory Committee (CAMAC) entitled Rehabilitating Large and Complex Enterprises in Financial Difficulties recommended there be no change to the current position where ipso facto clauses can be enforced. CAMAC acknowledged the arguments for prohibiting the enforcement of ipso facto clauses during the voluntary administration period, including:

- Directors may be reluctant to place their companies into voluntary administration because of concern that this may result in counterparties exercising their right to terminate under an ipso facto clause.

- The minimal detriment to the counterparty if the contract stays on foot.

- The benefit to administrators in the initial stages of the administration.

[4] M J Blazic, *In search of a Corporate Rescue Culture: A review of the Australian Part 5.3A Legislation,* University of Wollongong, 2010.

- The interference with the doctrine that all creditors are treated equally in the administration.

CAMAC, however, considered the arguments against extending the moratorium which exists in a voluntary administration to include ipso facto clauses too strong to recommend a change. Those arguments included:

- A counterparty can draft around an ipso facto clause to achieve the same effect (for example, providing a termination clause for an event just short of insolvency).
- Companies may find it difficult to obtain finance if secured creditor rights are further impinged.
- The necessity to protect the counterparty's rights in a voluntary administration.
- The difficulty in identifying ipso facto clauses.
- The commercial consequences of interfering with a counterparty's rights outweigh the benefit to companies in voluntary administration.

We consider these countervailing arguments weak. Most commercial contracts already provide for express rights of termination for breaches of terms, including non-payment for goods and the common law allows a counterparty to repudiate a contract in such circumstances.

The existing voluntary administration regime limits secured creditors from enforcing their rights to possession of secured assets for a limited period. Prohibiting enforcement of ipso facto clauses during voluntary administration would not further impinge a secured creditor's rights. To that end, we also note that if an administrator is trading the business during the voluntary administration process, the administrator is personally liable for that trading. That personal underwriting would not disappear if, for a period of time, ipso facto clauses were not able to be triggered. Continuation beyond a legislated moratorium "window" would then be on terms as agreed between the parties.

Finally, a clause that has the effect of giving the counterparty the right to terminate the contract upon the company entering into voluntary administration, regardless of how the counterparty classifies the clause, is an ipso facto clause.

In our view, the introduction of legislation providing some moratorium from the triggering of ipso facto clauses by formal insolvency appointments will significantly enhance opportunities for recoveries for relevant stakeholders.

6. <u>Some submissions suggest that current arrangements are too complex and costly for SMEs. For example, SME owners are often personally liable when the business is in financial distress, and there are costs associated with navigating the corporate external administration and bankruptcy regimes.</u>

As set out in Section 3 of this submission, whilst the costs associated with external administration regimes are typically higher when the administration involves a large, complex business, there are circumstances where the work required (and therefore costs accrued) to administer SMEs can be significant. To that end (and with specific reference to Discussion Point 6 above), the liability of owners or directors of failed SMEs is largely irrelevant in the context of the aims of Australia's external administration regime.

There are a number of mechanisms in place which are designed to ensure that creditors and other stakeholders are not burdened by unreasonable fees and expenses. For example, insolvency practitioners who are members of ARITA must uphold the rules and regulations of the ARITA Code, which governs the insolvency regimes in Australia. Particularly, voluntary administrators must abide by the ARITA Code prior to, and during, a voluntary administration. Part of this involves a requirement to disclose to directors of the company (including directors of SMEs) the basis of fees to be charged and the estimated costs of undertaking an administration.

Importantly, the costs of the voluntary administration or liquidation process only crystallise when they are ratified by creditors or the court. In this regard, if the costs are deemed to be excessive in the eyes of creditors and are therefore not approved, the only way an insolvency practitioner can be paid is by convincing a court that the fees incurred were reasonable in the circumstances. As a result, safeguards already exist to ensure that external administrations do not become unnecessarily costly. Creditors of SMEs will ratify fees that are suitable in the circumstances, just as creditors of larger businesses will ratify fees that are suitable in their particular circumstances.

The ARITA Code, as well as the legislation, have arrangements in place to deter rogue practitioners from acting against the interests of creditors (for example by charging unjustifiably high fees). In addition, the Companies Auditors and Liquidators Disciplinary Board (**CALDB**) was established to enact disciplinary action against liquidators when required (refer also to our comments in Section 7 below). The existence of CALDB is another step in place to prevent administrations from becoming unnecessarily costly.

For the most part, the existing arrangements are flexible enough to suit the complexities of each external administration from a cost perspective.

7. <u>In some cases, liquidator misconduct in areas of improper gain, including excessive remuneration, and liquidator independence and competence affect the cost and effectiveness of liquidation for SMEs.</u>

Although this is a topic of understandable sensitivity for creditors and other stakeholders of failed businesses, the general public, politicians and also for the restructuring, turnaround and insolvency profession, our observation is that only a small minority of registered liquidators breach the laws or do not act in good faith. In our view the small number of miscreants is an indicator of the success of the mechanisms currently in place to supervise and monitor liquidator behaviour, as described further below, in order to protect creditors and ensure the efficient undertaking of external administrations.

ASIC data[5] suggests that there has been a reduction in liquidator misconduct in recent years. In particular, reports of alleged misconduct by registered liquidators reduced from 539 cases in 2011, to 446 in 2013. ASIC also highlights that greater than 70% of all independence declarations reviewed by their office in 2013 were deemed 'adequate' compared to less than 50% in 2012. Further, as at December 2013, only 19 registered liquidators (out of a total of approximately 700) were subject to formal investigation or enforcement action during the reporting year. This may well reflect the increasingly stringent requirements of the ARITA Code which suggests that self-regulation of the industry is in fact having a positive impact.

In addition to ASIC's monitoring and enforcement powers, CALDB is obligated by the *Corporations Act 2001* to determine whether a registered auditor or liquidator should be dealt with under section 1292 for any of the reasons outlined in the *Act*. Actions which can be taken against liquidators who fail to comply can include cancellation or suspension of the liquidator's registration; reprimanding of the liquidator; requirement for the liquidator to give an undertaking; and a potential order regarding costs of any proceedings.

For the 2013 reporting year there were only four matters before the CALDB and one administrative matter in relation to liquidator conduct.

Additionally, professional membership bodies including Chartered Accountants Australia and New Zealand, CPA Australia and ARITA have their own methods of dealing with complaints in relation to their members and enacting disciplinary action.

We are unable to point to any evidence to support the assertion that liquidator misconduct adversely affects the cost and effectiveness of administrations of SMEs more so than larger businesses. We do, however, repeat our earlier views that the various professional and regulatory bodies administer a thorough and comprehensive registration process which ensures that the vast majority of liquidators are highly

[5] *REPORT 389: ASIC regulation of registered liquidators: January to December 2013*, ASIC, 2014.

competent professionals who carry out their work with the interests of creditors remaining paramount, whether for SMEs or larger enterprises.

Finally, we stress the importance of ensuring the restructuring, turnaround and insolvency profession is regulated and that practitioners operating in these areas are required to be appropriately experienced, qualified and supervised.

8. <u>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.</u>

We agree with the assertion that there is little empirical evidence to support the contention that Australia's voluntary administration regime is causing otherwise viable businesses to fail. Per our comments in Section 5 of this submission, our view is that the appointment of voluntary administrators results from the financial position and performance of a company.

The purpose of the voluntary administration regime is to assess the viability of the company's business or businesses. To the extent that a viable business exists, the voluntary administration process provides for that business to be preserved through a Deed of Company Arrangement or a sale.

Notwithstanding our comments above, we are aware of a small number of circumstances where enterprises (both large and small) would not have entered into external administration but for the personal liability attaching to directors from insolvent trading.

We also note our comments in Section 5 of this submission regarding the adverse impact ipso facto clauses have on attempts to restructure businesses once they have entered voluntary administration. As we have outlined, the very nature of ipso facto clauses can cause the loss of major contracts, but it is not the voluntary administration process that is resulting in the failure of otherwise viable businesses.

9. <u>The Australian Government released proposals in 2012 to improve liquidator competence, align corporate insolvency and bankruptcy, and promote market competition on price and quality. These proposals seek to mitigate administrative costs for SMEs and curtail the escalation of time-based fee entitlements.</u>

In relation to the proposals contained in the draft Insolvency Law Reform Bill 2012, we refer to our submission dated 8 March 2013 to the Corporate Governance and Reporting Unit of the Corporations and Capital Markets Division of the Treasury, which is attached as Annexure A to this submission. That submission sets out the proposals we agree with, those we don't and those in relation to which we believe further clarification or amendment is required.

This submission sets our comments regarding the costs of external administration generally and in relation to SMEs specifically in Sections 3 and 6. In summary we believe the existing regime, including the requirements of the *Corporations Act 2001* and the ARITA Code, provides adequate protection against unjustifiable fee escalation for all administrations, whether they are in relation to SMEs or larger, more complex enterprises.

Our views on:

10. No change to current arrangements.

As described in the previous sections herein, in our view Australia's external administration regime is, on the whole, robust and we support it. It has adequate flexibility to deal with the full spectrum of size, nature and complexity of distressed and insolvent enterprises.

Although there are a small minority of practitioners who act in an improper manner, the existing regime, through the various provisions in the Corporations Act and the ARITA Code, provides appropriate safeguards for creditors and other stakeholders to address practitioner misconduct and ensure transparency in the remuneration approval process.

Further, the work undertaken by ASIC in relation to investigating complaints against liquidators serves to ensure that practitioners are, in the main, acting in a proper manner. We do note, however, that additional resources/funding for ASIC may result in ASIC being able to investigate rogue practitioners in a more timely and robust manner.

Notwithstanding our comments above, we believe the current regime could be improved through:

- The introduction of a director safe harbour (via a business judgement rule) to encourage an increased number of informal restructurings and turnarounds; and

- The implementation of a moratorium on ipso facto clauses in order to maintain the value of assets of distressed businesses, which would improve the prospects of formal restructuring though the voluntary administration process.

We believe the implementation of those changes would result in a better balance between protecting creditors' interests and supporting sensible commercial risk taking.

11. Implement the 2012 proposals to reduce the complexity and cost of external administration for SMEs.

A Treasury media release in relation to the draft Insolvency Law Reform Bill 2012 stated that the proposals would amend the personal and corporate insolvency laws to improve regulatory oversight of the insolvency profession, improve value for money for recipients of insolvency services, and enhance creditor rights across all forms of insolvency administration. The media release also explained that the draft laws would provide greater powers for creditors to remove practitioners and curb excessive fees, and therefore deliver better outcomes for creditors, many of whom are small businesses.

In discussing the 2012 proposals, the Government appears to focus on the reduction in complexity and costs, particularly for small businesses, in more closely aligning the personal and corporate insolvency regimes in a number of key areas. While these amendments may improve consistency and reduce complexity for employees, creditors and practitioners where they encounter both personal and corporate insolvencies, we do not foresee this leading to large cost savings for any parties in comparison to the current regime.

Our submission dated 8 March 2013 to the Corporate Governance and Reporting Unit of the Corporations and Capital Markets Division of the Treasury (attached as Annexure A), sets out our comments and observations regarding the 2012 proposals.

With reference to costs, the main 'cost saving' elements of the 2012 proposals appear to relate to assumptions regarding the increased likelihood of:

- External reviews of administrations and fees, resulting in practitioners being more conservative with charging time-based fees and disbursements.
- Greater regulation and discipline for rogue practitioners, reducing the incidence of practitioners over-charging or diminishing the returns to creditors as a result of some other dishonest or inappropriate behaviour.

We have a contrary view and believe there is a real risk that the elements above will lead to an increase in costs, including as a result of the additional reporting requirements for insolvency practitioners. In addition, the proposed increased powers of creditors in relation to meetings and removing practitioners is likely to lead to an increased incidence of practitioners seeking the court's imprimatur in relation to fees and the conduct of administrations more generally, which is likely to result in more expensive administrations.

12. Is there evidence that Australia's external administration regime causes otherwise viable business to fail and, if so, what could be done to address this?

In our view there is little evidence to suggest that otherwise viable businesses fail as a result of Australia's existing external administration regime.

Our experience suggests that companies fail for a variety of reasons, including macro-economic factors such as the relative strength of the Australian dollar and factors which influence micro-economic decision-making such as poor management information systems. The view that financial failure is caused by Australia's external administration regime is misguided and is in no way statistically supported. We note the complainants on these issues tend to be creditors who take a trading risk every day and whose own business dynamics will govern, to a large extent, how supportive of another business (or a restructured business) they will be.

As addressed in this report, there are some shortcomings in the current regime that may limit the ability of a viable business to emerge from an external administration. Those shortcomings include misconduct by a small minority of insolvency practitioners and the lack of a moratorium on the enforcement by suppliers/creditors of ipso facto clauses, the existence of which can dramatically inhibit the chances of a successful restructure and/or diminish the realisable value of assets.

Concluding comments

In our view Australia's existing Corporations Act legislation, and the external administration provisions within the Act, provide sufficient flexibility to allow the efficient recycling of capital for the benefit of the economy. Importantly, we do not believe the current regime causes viable businesses to fail.

We do believe, however, that certain changes to the current regime should be considered. Those changes include a moratorium on the enforcement of ipso facto clauses and the introduction of a safe harbour for directors (via the introduction of a business judgement rule), both of which are likely to increase the chances of a successful workout (formal or informal) for distressed businesses and/or result in the value of assets, the associated return to creditors and the value of capital recycled into the economy, being maximised.

FERRIER HODGSON

Annexure A