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29 July 2011

Mr Tim Beale
Manager, Governance and Insolvency Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
Parkes ACT 2600
Email: insolvency@treasury.gov.au

Dear Mr Beale,

Options Paper: a Modernisation and Harmonisation of the Regulatory Framework Applying to Insolvency Practitioners in Australia

The Australian Institute of Company Directors welcomes the opportunity to comment on the *Options Paper: A Modernisation and Harmonisation of the Regulatory Framework Applying to Insolvency Practitioners in Australia* (Options Paper).

The Australian Institute of Company Directors is the second largest member-based director association worldwide, with over 29,000 individual members from a wide range of corporations; publicly-listed companies, private companies, not-for-profit organisations, charities and government and semi-government bodies. As the principal Australian professional body representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

The issue of corporate insolvency and the mechanisms by which the value of a business can be preserved, as far as possible, during an insolvency event is an area of concern for directors. Finding the balance between a regime which encourages entrepreneurialism and protects the interests of all relevant corporate stakeholders is also critical to ensuring the health of the Australian economy. It is on this basis that we respond to the request for comments on aspects of the Options Paper below.

1. Summary

In summary, the Australian Institute of Company Directors is of the view that:

(a) efforts should be taken to reduce the incidence of fraudulent phoenix activity, however, there are issues with the proposals to "streamline" the director disqualification process;

(b) there is no case for automatically disqualifying directors on the basis of company failure alone;

(c) ASIC should not be vested with any additional power to disqualify a director beyond that which it already possesses under s206F of the Corporations Act 2001 (C'th); and

(d) until the Corporations Act includes a business judgment rule defence for insolvent trading, the current regime will not be effective and will not "save businesses that can be saved."

2. Fraudulent Phoenix Activity and Disqualification of Directors

We note the concerns in the Options Paper regarding fraudulent phoenix activity. The Australian Institute of Company Directors shares these concerns and recognises that fraudulent phoenix activity is an abuse of the limited liability privilege granted through the corporate form to conduct business.

While we strongly support efforts to reduce the incidence of fraudulent phoenix activity, we have concerns about the suggestions in the Options Paper to "streamline" the disqualification process of directors.

Disqualifying a director from managing a corporation is a serious penalty and has wide ranging ramifications for the director involved. For this reason, the process for making a disqualification order should be commensurate with the seriousness of the consequences. Despite this, the Options Paper discusses *automatic* disqualification of directors and requests comments on whether:

(a) there is a case for automatic disqualification of directors after a company failure?[1] and

(b) ASIC should be able to automatically disqualify a director of an insolvent company who has not taken reasonable steps to ensure that the company has maintained its financial records?[2]

The Australian Institute of Company Directors is of the view that there is no case for automatically disqualifying directors on the basis of company failure alone. Further, we strongly oppose ASIC being vested with any additional power to automatically disqualify a director who has not taken reasonable steps to ensure that the company has maintained its financial records.

The Australian Institute of Company Directors strongly believes that there are a range of existing provisions under the Corporations Act and other legislation which can assist regulators to pursue and hold to account those involved in fraudulent phoenix activity. In particular, we refer to the 'trading while insolvent' provisions in Part 5.7B of the Corporations Act and ASIC's existing powers to disqualify persons from managing corporations where they have been involved in corporate collapses (under s206F).[3]

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[1] Discussion question 680 provides: *Is there a case for automatic disqualification of directors after a company failure? If so, how many repeated failures should trigger disqualification? Should there be a threshold for failures to trigger disqualification (for example, where less than 50 cents in a dollar are returned to creditors?) Over what period must the failures occur?*

[2] Discussion question 682 provides: *Should ASIC be able to automatically disqualify a director of an insolvent company who has not taken reasonable steps to ensure that the company has maintained its financial records?*

[3] We previously raised these concerns with Treasury in our submission responding to the *Treasury Proposals Paper – Action Against Fraudulent Phoenix Activity* on 22 December 2009. A copy of this submission is available at www.companydirectors.com.au

Directors have a duty to prevent insolvent trading.[4] To avoid breaching this duty, directors of an insolvent company will generally be required to put the company into voluntary administration. However, if the proposals suggested in the Options Paper are adopted, company directors that comply with the law in this regard will automatically be disqualified. This is contradictory in principle and discourages compliance with the duty the law currently prescribes for directors.

It is critical to remember that a company may be placed into external administration for a range of reasons, including external economic or market related pressures. It does not follow that because a company has been placed into external administration that a director has acted improperly, incompetently or has failed to discharge his or her duties. Arguably, disqualifying a director is akin to a restraint of trade which restricts the liberty of a director to carry on their trade in the future. In circumstances where a director is automatically disqualified without a finding of personal culpability, it is difficult to see how such a restraint could be justified.

Automatically disqualifying directors solely on the basis that a company has failed would also have a chilling effect on Australian innovation and creativity. History shows that some of the world's most successful products and services have emanated from entrepreneurs whose companies had failed previously and on numerous occasions.

In addition to stifling innovation, automatically disqualifying directors because a company has failed, acts as strong a disincentive for directors to accept positions with companies in financial stress. This in turn limits the ability of small and large companies to attract directors who could assist to guide the company through its financial difficulties.

The Australian Institute of Company Directors does not support an extension of ASIC's powers to automatically disqualify directors who have failed to deliver to a liquidator an insolvent company's financial records. It is important to recognise that when a company enters into voluntary administration the administrator takes control of the company's business, property and affairs. If this occurs, the non executive directors will not be in a position to deliver to a liquidator an insolvent company's financial records. To disqualify a director who is in no effective position at law to deliver or to instruct the delivery of financial records would be an illogical outcome.

As set out in the Options Paper, "the Corporations Act currently imposes strict requirements on all companies to keep written financial records that correctly record and explain its transactions and financial position and performance."[5] If ASIC has reason to suspect that these requirements have not been followed, ASIC should use its existing powers to commence actions against these companies and the directors involved.

Although automatic disqualification may be attractive for ASIC in terms of administrative convenience and cost effectiveness, disqualification is a serious prohibition and its gravity should be reflected in the process by which disqualification orders are made. As we have stated previously there are certain inherent problems in allowing such penalties to be determined by a regulator (who is effectively the prosecutor).[6] Ideally, only courts should have the power to disqualify directors after full

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[4] Section 588G Corporations Act 2001 (C'th)

[5] Options Paper at page 104

[6] See for example, our submission to the Treasury Proposals Paper: *Action against fraudulent phoenix activity* dated 22 December 2009.

consideration of the facts and after a determination on the availability of any relevant defences. This is a fundamental rule of law issue. A person should not be deprived of the ability to continue in their chosen profession or trade without a fair hearing.

In summary, we strongly object to any extension of ASIC's powers in respect of the disqualification of directors and believe that ASIC should focus on using the existing provisions available to it, to regulate phoenix activity.

3. Extended Business Judgment Rule for Insolvent Trading

The Options Paper provides numerous alternatives for the reform of the insolvency framework and the regulation of insolvency practitioners. Unfortunately, the paper does not discuss the need to adopt an extended business judgment rule for insolvent trading.

The Australian Institute of Company Directors has long called for a broad business judgment rule defence to be inserted into the current insolvency regime. This issue was formally considered in the *Discussion Paper, Insolvent Trading: A 'safe harbour' for re-organisation attempts outside of external administration'* in January 2010. Despite the submissions provided to Treasury on this issue, as far as we are aware, the Government has not provided a response to the views raised as a result of that discussion paper. We have since re-iterated our concerns regarding the need for an extended business judgment rule in a letter to the Hon David Bradbury, following the release of the *Senate Economics References Committee Report: The Regulation, Registration and Remuneration of Insolvency Practitioners in Australia.*[7]

The extension of the business judgment rule defence to cover insolvent trading is important because the question of whether a company is insolvent is an extremely complex one and time-dependent. The current insolvent trading laws make trading out of financial difficulties not only extremely risky but prohibit it for the directors of a company in solvency stress. Each director faces being held personally liable for any further debts incurred unless the company is placed in external administration, leading in many cases to a worse outcome for its shareholders and other stakeholders than would be obtained by allowing the company to trade out of its difficulties.

A regime which forces directors to prematurely place their business into external administration to avoid any risk of personal liability prevents the best stakeholder outcomes from being achieved. In effect, directors of a company in solvency stress are liable to be faced with an acute conflict of interest between, on the one hand, protecting themselves from the serious consequences of insolvent trading and, on the other hand, securing a better probable outcome for the company's shareholders and other stakeholders than is likely to result from putting the company into administration.

In this regard we note the comments made by the former Chief Justice of the Supreme Court of NSW, the Hon Justice Spigelman AC, who stated:

> "There are thought to be cases where directors have prematurely put their company into external administration, diminishing enterprise wealth and possibly destroying businesses in order to avoid exposing their company and themselves to breaches of insolvent trading or continuous disclosure law. If the Australian law has that effect, then the law is at odds with economic policy goals and needs to be reformed."[8]

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[7] A copy of this letter dated 24 September 2010 is available on our website at www.companydirectors.com.au
[8] Supreme Court Annual Corporate Law Conference *'Restructuring Companies in Trouble: Director and Creditor perspectives'* Conference Papers: Welcome by the Chief Justice dated 15 August 2010.

We note that in the foreword to the Options Paper, the Hon David Bradbury and the Hon Robert McClelland state: "Effective insolvency frameworks are essential if financial distress is to be addressed in a manner that minimises negative outcomes for creditors, debtors, consumers and employees. *Effective regimes save businesses that can be saved.*"

Respectfully, we are of the view that until the Corporations Act includes a business judgment rule defence for insolvent trading, the current regime will not be effective and will not "save businesses that can be saved."

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We hope that our comments will be of assistance to you. If you are interested in any of our views please do not hesitate to contact me or Leah Watterson on +61 3 8248 6600.

Yours sincerely,

John H C Colvin
CEO & Managing Director