Submission: Improving Bankruptcy and Insolvency Laws

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Improving Bankruptcy and Insolvency Laws

Worrells Solvency + Forensic Accountants is a specialist insolvency firm established in 1973. We have 21 offices across Queensland, New South Wales, Australian Capital Territory, Victoria and South Australia. We are a 24 partner firm and among our partners and consultants, there are 24 registered and official liquidators and 19 registered trustees. The business remains Australian owned and operated and is one of the country's largest insolvency firms.

On behalf of Worrells, I am pleased to submit our submission in response to the Improving Bankruptcy and Insolvency Laws discussion paper. We support reform and modernisation of insolvency laws and our detailed submissions regarding the proposals set forward by the Government can be found herein.

Worrells would also like to acknowledge that there were a number of other recommendations relating to insolvency law reform by the Productivity Commission in its Inquiry Report on Business Set-Up Transfer and Closure. These include, but are not limited to streamlined SME liquidations and pre-positioning sales. Worrells would welcome further discussion on all the productivity commission recommendations as part of the continued consultation about insolvency law reform.

Yours sincerely

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Contents

1. Reducing the Default Bankruptcy Period

We support the objectives of the proposed reform. We provide our response to the proposals below.

Query 1.1 – Objection to discharge

The Government seeks views from the public on whether the criteria for lodging an objection and the standard of evidence to support an objection should be changed to facilitate a trustee's ability to object to discharge.

Objection to discharge is one of the most efficient and effective mechanisms to:

- Incentivise bankrupts to comply with their statutory obligations; and
- Discourage misconduct by bankrupts.

Assuming the one year period for bankruptcy is introduced, we provide below our response with regard to a trustee's right to object to a discharge.

By way of background, a trustee can only file notice of objection to discharge prior to discharge from bankruptcy (Section 149B). There is a proposal to extend the obligation to make income contributions beyond discharge from bankruptcy. Where a discharged bankrupt has ongoing obligations to the trustee and the bankrupt estate, we submit that the existing objection to discharge process would be ineffective.

It is our submission that the criteria for filing an objection to discharge be changed to accommodate the proposed extension of obligations after discharge. We suggest that this can be achieved in either of the following two ways:

1. Amendment of Section 149B so that at any time within 2 years after a bankrupt is discharged from bankruptcy under section 149, the trustee may file with the Official Receiver a written notice of objection to discharge. This would likely necessitate a provisional discharge from bankruptcy after 12 months and full discharge after the expiry earlier of three years or the expiry or withdrawal of the objection to discharge.

2. Amendment of Section 149B so that at any time before a bankrupt is discharged from bankruptcy under section 149, the trustee may file with the Official Receiver a written notice of objection to discharge, and within 2 years after a bankrupt is discharged from bankruptcy under section 149, that the trustee may file with the Official Receiver a written notice requesting the reinstatement of the bankruptcy.

Query 1.2.1a

The Government seeks views from the public on which particular obligations on a bankrupt should continue even after a bankrupt is discharged.

Administration of complex bankrupt estates can take many years to complete and it is common for administration of such bankrupt estates to continue even after discharge. If the term of bankruptcy is decreased to one year, this situation will become even more prevalent and difficult to manage. Therefore, we submit that all obligations of a bankrupt to assist the trustee in the administration of a bankrupt estate should continue after a bankrupt is discharged.

Query 1.2.1b

The Government seeks views from the public on what incentives and mechanisms should be in place to ensure compliance with obligations after discharge.

We proposed in response to Query 1.1 that the criteria for objecting to discharge should be amended to facilitate a one year term of bankruptcy. This would be one mechanism to ensure compliance with obligations after discharge.

We proposed in response to Query 1.2.1a that all obligations for bankrupts to assist trustees should continue after discharge. Any compliance offences associated with those obligations should also continue after discharge.

Proposal 1.2.2

The Government proposes to separate the obligation to pay income contributions from the default bankruptcy period. Instead, individuals will continue to pay income contributions for three years even with the reduction in the default bankruptcy period. Further to proposal 1.1 above, where the period of bankruptcy is extended to five or eight years, income contributions will also be payable for that extended period.

We support this proposal and we believe it is necessary to ensure that creditors are not disadvantaged by diminished commercial returns from income contributions.

Query 1.3.1

The Government seeks views from the public on whether it is appropriate to reduce the retention period for personal insolvency information in credit reports.

Reduction of the reporting period would aid the objectives of financial rehabilitation and making it easier for entrepreneurs to obtain credit and succeed in business going forward. Therefore, we support the initiative to reduce the retention period for personal insolvency information in credit reports. We also note that credit reporting assists good credit practices and reduces wastage of credit resources on bad debts. This, in turn, assists to make more credit available to innovators and entrepreneurs. We submit that a suitable retention period for personal insolvency information might be two years after discharge.

2. Safe Harbour

We support the introduction of a Safe Harbour defence against insolvent trading, subject to there being adequate protection to prevent exploitation of the defence by directors.

We believe directors must be able to prove intent to rely on the defence at the time of embarking on turnaround initiatives and that there was a realistic expectation of success. For this reason, it is our submission that to ensure the integrity of the insolvent trading laws, if the directors wish to rely upon the safe harbour defence, it is necessary for the company to obtain independent advice from an appropriately qualified professional prior to any turnaround initiative.

Query 2.2

Subject to the further information on the proposal set out in the sections below, the Government seeks views from the public on whether this proposal provides an appropriate safe harbour for directors.

For the reasons outlined above, we support Proposal 2.2 in preference to proposal 2.3. The requirement for independent advice by a restructuring advisor means that directors can establish a bona fide basis to rely upon the defence. The defence would therefore not be open to abuse by a director who contrived the argument after the event.

The integrity of such a law would be dependent upon the independence, qualifications, licensing and regulation of restructuring advisors. The law should also contemplate what a reasonable person would undertake were they to be in the position of the director at the time and seeking an appropriately qualified person to provide that advice.

The relation back date for the defence should be clearly defined. Directors should not be able to rely on the defence for behaviour prior to receiving advice or after the completion/termination of the restructuring program.

We submit that Directors should not be able to rely on the defence for activity that is:

- Outside the scope of the restructuring advisor's advice; or
- After the turnaround initiative has completed; or
- After the turnaround initiative has failed; or
- Used for the purpose of creating an outcome that intentionally avoids paying creditors.

These are subjective matters and will probably necessitate a reasonable person test as discussed above.

Query 2.2.1a

The Government seeks views from the public on what qualifications and experience directors should take into account when appointing a restructuring adviser and whether those factors should be set out in regulatory guidance by the Australian Securities and Investments Commission, or in the regulations.

A restructuring advisor would require skills similar to that of a registered liquidator, primarily:

- Detailed knowledge of insolvency law and practice – To ensure that the advice given does not unfairly prejudice, or is not likely to unfairly prejudice creditors or other stakeholders.

- Advanced financial analytical skills – To understand and critically analyse financial information, to test financial data for reliability, to test assumptions and to test budgets and projections.

- Commercial skills in a distressed situation – the ability to focus on the key areas of distress when undertaking a restructure of the business often with a focus on cash flow.

- Experience and proficiency in business turnaround initiatives – To critically consider and assess the likelihood of success of particular turnaround initiatives.

Other professions, industry experts and foreign turnaround experts also have valuable skill sets but most will not have sufficiently well rounded knowledge to ensure the integrity of the proposed legislative instrument. Such experts would play a valuable role consulting with the company or the restructuring advisor but should not be regarded as restructuring advisors for the purpose of the legislation.

Query 2.2.1b

The Government seeks views from the public on which organisations, if any, should be approved to provide accreditation to restructuring advisers if such approval is incorporated in the measure.

We submit that the accreditation, registration and regulation of restructuring advisors should be similar to the accreditation, registration and regulation of registered liquidators in the Insolvency Law Reform Act 2016:

- ASIC should maintain a registry of restructuring advisors.
- A panel containing ASIC and ARITA should consider registration of restructuring advisors.
- A panel containing ASIC and ARITA should consider discipline of restructuring advisors.
- Prescribed professional bodies should have the ability to refer the conduct of one of their members to ASIC for review.

Query 2.2.1c

Is this an appropriate method of determining viability?

The proposed tests for viability are:

Whether a company can:

- Avoid insolvent liquidation, and
- Be returned to solvency within a reasonable period of time

In our submission, these are insufficient for the following reasons:

- They focus on short term outcomes. A company could meet these tests by soliciting a capital injection, but that would not address the long term viability of the company or sustainability for its purpose.

- They limit valued outcomes to solvency where as the primary motivator should be to maximise outcomes for creditors. For example, a business decision to continue to trade and enable an orderly sale of assets for fair market value might deliver better results to creditors than an immediate liquidation.

We see that there is an added advantage to focussing this reform on improved outcomes for creditors, rather than the narrower focus of business turnaround. It will indirectly assist in the regulation of the pre-insolvency market. Directors will likely prefer the advice of a registered restructuring advisor, who can offer a potential defence against insolvent trading, to that of an unregulated and unregistered pre-insolvency advisor. This could begin to provide regulatory control over currently unregulated pre-insolvency industry.

We see significant scope for expanded roles for registered restructuring advisers in the pre-insolvency space in relation to pre-positioning, and informal workouts.

Query 2.2.1d

What factors should the restructuring adviser take into account in determining viability? Should these be set out in regulation, or left to the discretion of the adviser?

We propose that additional tests should include:

- That the company's business ventures are sustainable; and
- If the company has implemented or will implement internal changes and controls to address deficiencies in its business processes that caused, or could cause, financial difficulties;
- What are the key cash flow constraints causing the financial distress of the business; and
- If solvency cannot be achieved, the outcome for creditors is better than the outcome that would likely have resulted from the immediate appointment of an administrator or liquidator.

There will be a number of factors unique to each individual appointment for restructuring advisors to consider. If the government accepts our recommendations as to the qualification requirements of restructuring advisors, it will likely be sufficient to trust the profession to develop best practice policies and guidelines and to trust restructuring advisors to exercise discretion and apply those principles properly.

If qualification standards for restructuring advisors are set too low, it will be necessary for factors relating to viability to be set out in regulation. The result would be a system that is inflexible, inefficient and occasionally unsuited to the peculiarities of specific appointments.

In setting an appropriate standard and experience level for restructuring advisers, consideration should be given to the financial planning industry and the various guidelines and regulations developed due to periods of poor advice. We should be careful not to set such a low standard that over the initial period of this legislation, it is abused and creates a poor perception of the industry.

Query 2.2.1e

The Government seeks views from the public on whether these are appropriate protections and obligations for the restructuring adviser, and what other protections and obligations the law should provide for.

We find the suggested protections and obligations for restructuring advisors appropriate.

Query 2.2.2a

Do you agree with this approach?

We agree with the approach, subject to the following emphasis of matter:

A director who is guilty of insolvent trading will often be guilty of a breach of director duties under sections 180 to 183 of the Corporations Act. It logically follows that a director who properly invokes the safe harbour defence for insolvent trading would generally be acting in

good faith in the best interest of the company and creditors, and therefore unlikely to breach his/her duties in that regard. However, care should be taken in drafting the legislation to ensure that directors protected from insolvent trading aren't otherwise at risk of liability for breach of directors' duties for insolvent trading.

Query 2.2.2b

Do you agree with our approach to disclosure?

We agree with the approach.

Query 2.2.3

The Government seeks views from the public on in what other circumstances should the safe harbour defence not be available.

We agree with most of the proposed circumstances where safe harbour would not be included. The only exception is employee claims which accrue during the safe harbour period. This should be limited to wages/salaries and superannuation. This is because:

- Accrued entitlements such as annual leave, long service leave and sick leave are non-current liabilities and would be paid in the ordinary course of business if the restructuring is successful.
- Entitlements such as annual leave, long service leave and sick leave accrue as a result of statute and directors have little control over such entitlements.

We also suggest that additional circumstances where the safe harbour defence should not be available are:

- Where the company does not maintain adequate books and records in accordance with Part 2M.2 of the Corporations Act.
- In circumstances where the directors otherwise act unlawfully or unconscionably to achieve turnaround objectives.

Query 2.3

The Government seeks your feedback on the merits and drawbacks of this model of safe harbour.

We do not support Safe Harbour Model B.

This proposal could be exploited by directors who could contrive or fabricate an argument in hindsight to justify prior behaviours. Conversely, Safe Harbour Model A, which requires companies to obtain advice from a restructuring advisor, provides independent and verifiable legitimacy as to the availability of the defence.

We do not support a carve out in preference to a defence. The burden of evidence should be upon the director. We foresee that the evidentiary burden might be a significant impediment to liquidators commencing insolvent trading proceedings, and therefore diminish the efficacy of the existing insolvent trading laws.

3. Ipso Facto Clauses

We support the voiding of Ipso Fact clauses that seek to terminate contracts due to insolvency events. Such clauses are a significant impediment to genuine business turnaround attempts and contrary to the intentions of Part 5.3A of the Corporations Act.

Query 3.2a

Are there other specific instances where the operation of ipso facto clauses should be void. For example by prohibiting the acceleration of payments or the imposition of new arrangements for payment, or a requirement to provide additional security for credit.

We support a prohibition against Ipso Facto clauses similar to Section 301 of the Bankruptcy Act. We do not believe any further prohibition is necessary.

Query 3.2b

Should any legislation introduced which makes ipso facto clauses void have retrospective operation?

We support retroactive operation of a prohibition against Ipso Facto clauses.

Are there any other circumstances to which a moratorium on the operation of ipso facto clauses should be extended?

We do not support a limitation of the moratorium to certain types of insolvency administration. We submit that the moratorium should apply to all insolvency administrations. Specifically, the proposal does not extend the moratorium to liquidations, yet the Corporations Act confers upon liquidators the power to trade a company's business.

Query 3.2.1

Does this constitute an adequate anti-avoidance mechanism?

While we acknowledge that anti avoidance provisions may be necessary, we do not have specific recommendations. We suggest that it might be suitable for the minister to have the power to set anti avoidance provisions in the Insolvency Practice Rules.

Query 3.2.2

What contracts or classes of contracts should be specifically excluded from the operation of the provision?

While we acknowledge that it may be necessary to exclude certain types or classes of contracts from the provisions, we do not have any specific recommendations. We suggest that It might be suitable for the minister to have the power to specify types or classes of contracts that are exempt from the provisions in the Insolvency Practice Rules.

Query 3.2.3

Do you consider this safeguard necessary and appropriate? If not, what mechanism, if any, would be appropriate?

We agree that the right for counterparties to apply to the court is an appropriate mechanism.