Australian Bankruptcy & Insolvency: Problems and Solutions

Submission Summary

- Position on proposed changes
- Problems cited with the existing regime – what are we trying to solve?
- Philosophical starting point for reform – what are the important principles any reform must meet?
- Should failing businesses be saved – what are the costs and consequences for saving unprofitable businesses?
- Personal bankruptcy reform – reducing the period of bankruptcy is reasonable
- Background on SME and large business failures – what needs to be understood before considering reforms?
- Ipso Facto reform – a good proposal that will assist sustainable but over-indebted businesses to survive
- Safe harbour reform – an unnecessary and dangerous reform that will see advisors enriched at creditor's expense
- Overdue debts – what can be done to assist businesses to be paid in a reasonable time and crack down on phoenixing?
- ASIC's role – meaningful reform to insolvency requires ASIC to step-up enforcement and education initiatives
- The ATO's role – by compromising debts the ATO is subsidising "losers" that should be recapitalised or closed down
- Conclusions

Position on Proposed Changes

- ✓ Reducing personal bankruptcy to one year
- ✓ Changes to ipso facto clauses
- ✗ Safe harbour proposals

Problems Cited with Existing Regime

- Ipso Facto: Contracts that could remain in order are often terminated, destroying business value
- Director's Duties: Fear of being held personally liable, although prosecutions are extremely rare
- Overdue Debts: Some businesses are continually late in paying their suppliers with enforcement expensive and slow
- Phoenix Companies: Theft from employees, taxpayers and other businesses goes unpunished
- Personal Bankruptcy: Is the three years too punitive?
- Prepack Insolvency: Why is it so hard and is value being lost?
- Cost of Administration: If the business wasn't already dead does the cost of administration kill it?
- Safe Harbour: Can more businesses be saved? Will losses to creditors increase as a result?
- Director Training: Are directors adequately trained to assess solvency?

Philosophical Starting Point for Reform

- More risk taking is desirable, but risk must be taken with capital that is paid to take risk.
- Financiers and equity investors are in the business of taking risk and pricing risk.
- Employees, the ATO and trade creditors cannot be expected to monitor risk and price for it, or be expected to take expensive and complicated legal action to see that their debts are paid.
- Directors and senior management are best placed to monitor and manage the risk and solvency of a company. They are typically remunerated for this work and must bear responsibility for inappropriate business failure.
- Most businesses exit well (sale or wind-down), but a few fail badly and spread their losses through the economy.
- When insolvency occurs the legally recognised order of priority must be honoured.
- In insolvent and borderline companies the recovery of creditor's funds takes priority over shareholder interests.

Should Failing Businesses be Saved?

- Most sectors in an economy allow for new entrants/competition. The process of competition strengthens an economy in the long term as successful firms flourish by offering their customers a better value proposition. As a result, their customers are better off and use their improved position to strengthen their business or to spend on other things.
- A lack of competition causes economies to stagnate and become inefficient, with their exports lower quality and higher priced relative to other countries (e.g. Communist Europe).
- Successful businesses typically have better decision making, lower costs and are better capitalised. It is inevitable that some businesses will succeed and others will fail.
- When businesses fail the most immediate and obvious outcome is a reduction in employment and the demand for goods and services by the failed firm. However, other firms have or will take their place creating higher demand for employees, goods and services. This replacement economic activity is almost never as visible as the failed company.
- In the long term, the replacement of poorly performing businesses with better performing businesses helps an economy to thrive and increases the opportunities for income and wealth for all.
- Saving failing businesses comes with both short and long term costs (e.g. greater inefficiency, moral hazard) and is typically delaying inevitable change.

The Ansett Case Study

- In 2001 Australians had the choice of three mainline carriers, Ansett, Qantas and Virgin. Compass had tried twice in the 1990's to established as a third airline but failed both times.
- The introduction of Virgin in 2000 brought substantial price competition. Virgin had a much lower cost business model than Ansett and Qantas. Ansett's high cost business model (particularly aircraft and staff costs) wasn't matched by high levels of service. As a result, it lost customers to Virgin and was substantially unprofitable.
- As a result of the losses Ansett was dependent upon its parent company, Air New Zealand for financial support. When Air New Zealand needed financial support from the New Zealand government it chose to withdraw its support of Ansett. Insolvency quickly followed in September 2001.
- Despite substantial effort, Ansett was not able to be quickly turned around. Potential buyers sought government guarantees as they believed there was a high risk that Ansett would remain unprofitable.
- Whilst the loss of jobs when Ansett failed was well publicised, the employment generated by its competitors before and after Ansett failed went largely unnoticed.
- The substantially lower cost of air travel available now began with the new entrants that ultimately killed off Ansett. Had the duopoly of Ansett and Qantas remained, the cost of passenger air travel and cargo would be much higher.

Personal Bankruptcy

- The primary creditors in personal bankruptcies are banks, credit providers and utilities. Most individuals have limited knowledge of financial and legal processes regarding debt provision and insolvency.
- Banks and other credit providers are in the business of assessing risk and pricing appropriately. They expect that some portion of their loans will not be repaid in full and set their pricing and terms in light of that. The also have responsible lending obligations, that requires them to reject applications when customers are unlikely to be able to repay.
- Utility providers are often able to require deposits from customers they believe are higher risk, thus largely mitigating their risk. Their ability to influence late payers, by switching off the service, offering discounts for paying on time and/or recording defaults on the credit record of the individual provides avenues to prompt individuals to pay their debts.
- Changing personal bankruptcy from three years to one year will not materially increase default levels on debts due to banks, credit providers or utilities.
- To ensure that bankruptcy does not become repeatedly abused by individuals extensions to the standard one year bankruptcy should apply if (i) the bankrupt is uncooperative or thought to be hiding assets from the trustee or (ii) the individual has previously been bankrupt.

Small and Medium Business Failures

- Unlike personal insolvency, the primary creditors of SME businesses are other businesses, employees and the ATO. These creditors are not in the business of assessing risk and charging a margin for accepting that risk. There is a reasonable expectation that directors are the experts on the financial health of their companies and are best positioned to recapitalise or close their businesses if solvency is doubtful.
- The primary problem with SME failures is that businesses are waiting far too long to get advice and are trading insolvent for months or years before voluntary administrators are appointed. In the most recent ASIC data 78.5% of insolvencies had alleged misconduct with 4,135 cases having documentary evidence to support the allegations. Despite this, insolvent trading prosecutions are almost unheard of.
- It is common for companies to continue trading whilst a substantial backlog of employee, trade creditor and ATO claims grow. Often, it is only when a wind-up action is commenced that directors consider their duties to creditors.
- Whilst insolvent trading is sometimes due to a lack of legal and financial expertise, phoenix activity is rife. A 2012 report by PWC estimated losses from phoenix activity were $1.78 – $3.19 billion per annum. This is large scale theft and must be treated as such.
- Two responses are needed to these issues, education and deterrents/enforcement. ASIC is best placed to administer both of these. Potential responses are covered later in this submission.

Large Business Failures

- Unlike SME failures, large businesses have significant access to legal and accounting expertise, both inside their firms and from professional advisory firms. Directors of large businesses are typically well aware of their responsibilities.
- Despite the lack of prosecutions, directors frequently mention the fear of insolvent trading as something that holds back risk taking. There is a belief amongst some that their own assets could be lost even if they act appropriately.
- It is a commonly raised concern that insolvency occurs too early as a result of such fears. When pressed for an example of this actually occurring, the only case of merit is Henry Walker Eltin, where creditors were repaid in full and shareholders received $0.17 per share.
- Directors who are concerned about losing their assets from insolvent trading claims have numerous avenues to protect themselves. In the first instance, they can get legal and financial advice to ensure that their companies are not trading insolvent. Secondly, they can resign from the board should they be concerned about its financial position. Thirdly, they can raise additional capital for the business to underpin its solvency. Fourthly, they can mitigate their personal risk via professional services insurance and using trusts to hold their personal assets.
- Claims that Australia's insolvency system is draconian should be dismissed. There is virtually no evidence that insolvency is happening too early or that directors who perform their duties adequately are at risk.

Ipso Facto

- The proposed changes to ipso facto clauses are common sense and will do a great deal to allow sustainable but over-indebted companies to survive.
- Suppliers and customers should be entitled to have assurance that they will receive future payment or service provision as per their contract. This may require an administrator to pay for goods or services on delivery, provide a bank guarantee or deposit, pledge assets or other common methods of providing reassurance within reasonable limits.
- Ipso facto clauses should not apply to debt providers. Whilst their position can be stayed during insolvency, they should not be forced to provide additional credit (e.g. overdraft) once an event of default or insolvency has occurred.
- It is likely that as a result of changes to legislation regarding ipso facto clauses some future contracts will contain more clauses for termination and shorter notice/termination periods. This should not be overly concerning or fought against, contract counterparties should generally be allowed to terminate contracts if the terms have been breached.

Safe Harbour

- As discussed in previous slides, the issues cited as creating a need for safe harbour provisions are vastly exaggerated. Safe harbour provisions in either of the forms proposed are unnecessary and dangerous.
- Safe harbour provisions do not do anything that a voluntary administrator cannot already do to see a sustainable business survive. However, by leaving management and directors in control repayment of creditors is likely to worsen.
- If implemented, safe harbour provisions will enrich advisors and impoverish creditors. Safe harbour provisions allow businesses that are or are likely to be insolvent to extend the period in which they can seek solutions.
- This will most likely be concessions from creditors, as customers are unlikely to accept price increases and few will consider investing debt or equity into such a high risk venture. Advisors will earn substantial fees assisting with this process. These fees are very likely to come from funds that would otherwise be used to repay creditors.
- For shareholders, safe harbour provisions create a "heads I win, tails you lose" outcome. Creditors funds are gambled on seeking longshot solutions. In almost all cases, no solutions will be found and creditor losses will be increased. If shareholders and directors are unwilling to contribute additional funds to recapitalise the business, why should creditor funds be gambled?
- If there is a desire to see more businesses survive, the solution is for directors to be getting expert advice much earlier. By the time insolvency occurs or is being considered it is almost always too late for resuscitation measures to work.

Overdue Debts

- The failure of companies and governments to pay their debts on time is a substantial inhibitor to business activity. Slow payers are using their suppliers as an alternative to properly capitalising their business. Large businesses and governments that take months to pay legitimate invoices are abusing their size advantage. Delayed payments often cascade through industries, with companies struggling to pay their suppliers due to late payment by their customers.
- In some cases, creditors are turning to organised crime figures and bikie gangs to collect their debts. This is a particularly unsavoury outcome, largely due to the failure of businesses to pay debts and phoenix activities.
- Consideration should be given to introducing legislation that sets the standard payment term as 30 days, when no time period has been agreed in writing. Businesses would be free to contract other terms, when both parties consent.
- In the event a debt was outstanding 37 days after invoicing, the creditor would be entitled to formally serve a letter of demand. If the debtor fails to pay in full, or fails to contest the validity of the debt by an injunction within seven days the creditor would be entitled to seek a default judgement for an administrator to be appointed. Costs (both court and applicant costs) would be payable by the overdue debtor.
- The impact of this change would be that failing businesses would be dealt with much faster and phoenix activities would be substantially reduced. Whilst there would initially be a backlog of undercapitalised businesses failing after the legislation was introduced, in the medium and long term the economy would be far better off.

The Role of ASIC

- Consideration should be given to directors being required to attend training or complete an online test every three years. This would remind directors of their duties and their potential legal responsibility to make good losses if a company trades whilst insolvent.
- ASIC must take action to enforce insolvent trading laws. Prosecutions should be commenced on the most egregious cases with please explain letters sent whenever a liquidator concludes that insolvent trading was likely to have occurred. Failure to respond adequately to such a letter would see enforcement commenced.
- Directors who have presided over repeated company failures where insolvent trading has occurred should be banned for life from being a company director. Being a company director is a position of great responsibility. Those proven to be unable to handle those responsibilities should not be allowed to risk causing further losses to others.

The Role of the ATO

- The ATO is at the frontline in dealing with poorly managed and undercapitalised business. It is common that the ATO is the only creditor willing to expend the resources necessary to take legal action against recalcitrant debtors.
- Businesses collect GST and PAYG in the normal course and pay these amounts in arrears to the ATO. There is no reason that businesses should not be able to pay the ATO on time, as they have already received the GST or have held back the PAYG contribution from employee wages.
- The ATO process for dealing with recalcitrant payers is disorganised with substantial variation in treatment. As a result, some poorly managed and undercapitalised businesses rely on the ATO to fund their activities. The ATO is widely considered to the be the last creditor to be paid, with this position exploited by phoenix operators.
- By agreeing to debt compromises to “save” failing businesses the ATO is effectively “picking losers”. The ATO is using the tax system to provide subsidies to poorly run businesses with all other taxpayers bearing the cost.
- The ATO should introduce a strict payment policy, that if any material part of a debt is outstanding more than 37 days after the due date enforcement action is commenced. In the short term, this will see some undercapitalised and phoenix companies pushed into insolvency. In the long term, this will greatly reduce phoenix activities, speed up payments to employees/ATO/trade creditors and reduce subsidies given to failing businesses.

Other Needed Changes

- Pre-pack insolvency: Where a reasonable sale process has been run prior to insolvency and the majority of creditors likely to receive a recovery (by value) consent, pre-pack insolvencies should be encouraged. Pre-pack insolvencies allow over indebted but sustainable businesses to quickly transition to a more appropriate capital structure. Care must be taken that pre-packs are not used to phoenix business assets and that directors are still held accountable for losses inflicted on creditors.
- Cost of insolvency: The insolvency industry has acknowledged that there are a small number of bad apples. In the vast majority of cases these operators are known and ASIC has failed to act on the reports of misconduct made by peers and creditors. ASIC must take seriously its responsibilities in this area and investigate claims of abuses.

Conclusions

- The Australian business insolvency system is far better than many other countries but is not without flaws.
- Most business exits are well managed (wound-down on their own or sold) but a small number fail badly injuring employees, trade creditors and taxpayers as a result of their poor planning and bad management.
- The primary issue in these cases is that directors are failing to get advice and are trading whilst insolvent. This can be due to ignorance (more training is required) or phoenix activity (lack of enforcement), which is rife. For both cases the inaction of ASIC needs to be addressed as a priority.
- The proposed changes to ipso facto clauses are common sense and will do a great deal to allow sustainable but over-indebted companies to survive.
- The proposed safe harbour reforms are unnecessary and dangerous. Large companies are already negotiating with their financiers prior to insolvency, often for months or years. Safe harbour will enrich advisors at the expense of creditors.
- The process for enforcing overdue debts should be simplified and sped up. Businesses unable to pay their debts should be put into administration as soon as reasonably possible where their problems can be independently assessed.
- The ATO should be far more consistent and rigorous in enforcing debts. Compromising debts is "picking losers", with other taxpayers worse off. Forcing undercapitalised businesses to recapitalise or close down is the best outcome for Australian taxpayers, employees, trade creditors and the economy.

Narrow Road Capital Submission – Proposed Insolvency Changes

Background

The proposed insolvency changes cover three main areas: reducing the period for personal bankruptcy, legislating to make ipso facto clauses unenforceable and introducing a safe harbour protection for directors. Narrow Road Capital made a submission supporting the first two of these changes in May 2016. This 2016 submission has been attached with this document.

Personal Bankruptcy and Ipso Facto Clauses

Narrow Road Capital continues to support change for these two areas. The proposed changes for ipso facto clauses appear not to include standard bank loans including term loans and overdrafts. This is a very unusual approach and creates several complications if implemented.

Firstly, it implies that a borrower could continue to drawdown lending facilities after they have entered administration. For instance, a borrower could drawdown the facilities and use the funds to pay other creditors thus upending the pre-administration position of creditors. If the lender is a secured creditor, as is often the case, funds drawn down could be used to subvert the natural order of priority with additional credit obtained from a secured creditor and used to pay unsecured creditors and related parties.

Secondly, it appears that the proposed changes would block a secured lender from appointing a receiver. This raises the question of whether having a secured position would continue to be an effective risk reduction mechanism. If secured creditors are unsure of their position ex-ante, they may not lend at all or may charge a higher interest rate.

The government should consult widely and make available proposed solutions for these issues for public comment before proceeding with legislation.

Safe Harbour

The 2016 submission by Narrow Road Capital argued strongly and clearly that safe harbour protections are dangerous and unnecessary. The proposed legislation highlights the unworkability of safe harbour provisions and the breach of fundamental principles that safe harbour protections require. In short:

- There is no evidence that viable businesses are being destroyed as a result of existing insolvency legislation. The commonly used description of "draconian" has been proven wrong as there are no major cases of insolvency having occurred too early.
- Safe harbour provisions replace an independent administrator with existing management that has failed to keep the company in a solvent position and that has a vested interest. (e.g. continuing to earn a salary, pursuing long shot strategies to make their investment worth more than zero, covering up fraud or misconduct, avoiding director's liability for insolvent trading)
- Safe harbour is a "heads I win, tails you lose" scenario. Creditors funds are gambled in an attempt to create more shareholder value, with the most likely outcome that creditors losses are increased.
- It is a fundamental principle that someone must be responsible if a company incurs debts whilst trading insolvent. Safe harbour means that no one is responsible for further losses giving management a green light to steal from creditors.

- If a company is insolvent it means that directors and shareholders have been unwilling or unable to contribute more capital to continue operations. If these groups are not willing to invest more why should creditor's funds be gambled?
- Well run and solvent businesses are disadvantaged by safe harbour. Allowing companies that are non-current on their creditor payments to continue operating damages viable, well run businesses.

Having read through the submissions made by other groups and individuals, no decent argument has been put forward to support the introduction of safe harbour protections. However, the proposed safe harbour provisions create many problems including:

- There is no requirement for independent advice. Management can continue trading whilst insolvent believing that they are compliant when a cursory review by an expert, independent advisor may conclude that the situation is hopeless and administrators should be appointed immediately. Greater losses would be inflicted upon creditors as a result.
- There is no time limit on safe harbour provisions. If a business could not organise a plan whilst they were solvent, why are they granted further time once insolvent? If a plan cannot be formulated and executed within three months, why should a business be allowed to continue trading whilst insolvent indefinitely?
- There is no requirement for "skin in the game" by management or shareholders. If those closest to the financial position are not willing to invest more why should creditors funds be gambled?
- There is no one liable for losses incurred during the safe harbour period. As directors are no longer liable, this is a licence to steal from creditors whether they be employees, trade creditors or other taxpayers.
- There is no requirement to tell creditors of the financial position. If a business is continuing to trade whilst insolvent and there is no one liable for losses, why should employees, trade creditors and other taxpayers be left in the dark about the enormous risk being taken by trading with the business?
- New creditors can enter and old creditors can be repaid whilst the business is trading insolvent. There appears to be no protection against related party creditors or other favoured creditors being repaid ahead of others.

Consultancy Process

It is concerning that such fundamental flaws remain open when legislation is expected to be put before parliament in coming months. It appears that the submissions made in May 2016 were ignored and a predetermined pathway is being pursued regardless of the evidence. Repeated requests to discuss the proposed changes with the Financial System Division of Treasury have been ignored. It appears that the self-interested lobbying of company directors and legal practitioners has been accepted without scrutiny. The proposed legislation undercuts the efforts of the Fair Work Ombudsman (employees) and the Office of Small Business and Family Enterprise (trade creditors) to see that creditors are paid on time. Allowing unviable businesses greater latitude to steal from employees, trade creditors and other taxpayers is neither innovative or positive for economic growth.

It is not too late to consult widely, consider the major issues at stake and make recommendations that are in the best interests of all Australians. Narrow Road Capital again offers to be part of this process and to put forward the case on behalf of employees, trade creditors and other taxpayers that has so far been ignored in this process.

End of Submission

Written by Jonathan Rochford for Narrow Road Capital on 24 April 2017. Narrow Road Capital appreciates the opportunity to make a submission, feedback is welcome and can be sent to info@narrowroadcapital.com