25 Toulon Avenue
Wentworth Falls NSW 2782

17 July 2011

COR 2011/00773

Manager
Governance and Insolvency Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir

SUBMISSION ON "OPTIONS PAPER: A MODERNISATION AND HARMONISATION OF THE REGULATORY FRAMEWORK APPLYING TO INSOLVENCY PRACTITIONERS IN AUSTRALIA"

I refer to the above paper published by the Australian Government in June 2011.

BACKGROUND

I worked for the Insolvency Practice of one of the Big 4 accounting firms for eight years, both in the UK and Australia. I left the industry some time ago but stay in touch with the general trends. One of my major responsibilities when I was working for one of the major firms in Australia was to look at the internal processes of the insolvency practice and determine how clients could be serviced more efficiently. Therefore, as someone who no longer has a vested interest in the insolvency profession but considerable experience of it, I thought that my viewpoint might prove useful.

OVERALL COMMENTS ON OPTIONS PAPER

Overall, I was disappointed with the content of the Options Paper. It seems that, in response to a small number of well publicised events that the Government has reacted to events without necessarily understanding the forces that drive the industry.

The overwhelming focus of the paper is to increase regulation. Although a predictable Government response, this risks doing as much harm as good. The fundamental issue with the insolvency industry is that it is very expensive and seems to lack price competition. Increasing regulation will simply make it more difficult for new people to enter the industry, make it far more difficult for smaller firms to afford the level of compliance that will be necessary and simply add more bureaucracy to processes that barely work due to their complexity.

The primary beneficiaries of greater regulation will be the larger firms. Certainly, in my experience is that within these firms they see many of the issues of the insolvency industry as emanating from the 'smaller end of town'. However, I would point out that the polarisation of insolvency in a decreasing number of major firms is one of the primary reasons that the fees are so expensive and the price competition is absent.

The Options Paper seems to start from the viewpoint that insolvency is a very complex job, that most assignments are very different and therefore that high fees are maybe understandable. In fact, this does not represent the reality in many cases. Although the Options Paper does a good job of discussing the problems relating to professional fees, the options provided are mostly trivial and will not represent any significant change to the status quo.

The Options Paper does not seem to have included input from people on the 'other side' of insolvency procedures – the creditors, directors and staff of insolvent companies. There are many lessons to be learned from these parties.

Overall, the Options Paper recommendations, even if implemented, will not cause any significant change to the operation of the insolvency profession. The regulatory changes will simply add cost, reduce competition and not address the core issues behind practitioner misbehaviour. There are too many attempts at 'headline grabbing' changes, such as allowing the Committee of Inspection to direct a Liquidator, that in practice will be used seldom or never. The core drivers of the insolvency profession are not in fact addressed by these options.

AN INCENTIVE DRIVEN APPROACH

As a general rule, people behave the way they are incentivised to behave. In the case of the Options Paper, none of the incentives that drive the behaviour of Insolvency Practitioners ("IPs") is being changed in any meaningful way. Rather than attempt to modify behaviour by regulation, I would argue that identifying and addressing the incentives would be a better approach. This does, however, require changes to some primary legislation which is not envisaged by this review. However, the two matters (insolvency practitioner conduct and the laws under which they operate) cannot realistically be separated.

CORE INCENTIVES FOR RATES

History of IP fees

Prior to around 1998, the Insolvency Practitioners Association of Australia (IPAA) produced a recommended scale of hourly rates for insolvency work. This was hugely resisted by the larger firms, since the rates were less than other partners in large accountancy firms were able to generate and represented a discount on 'firm rates'. Generally, secured creditors would insist on using these rates when engaging any firm and the larger firms had no choice but to follow.

Clearly, IPAA rates represented an improper intrusion on a free market which was the reason for their removal. However, almost from the moment of their removal the effect was clear – the larger firms significantly increased their rates and most of the smaller firms followed. There is not much evidence of a 'free market' even when IPAA rates were abandoned.

As is the case with audit, there is in fact a limited choice of practitioners for any larger insolvency assignment. At least 2 of the Big 4 firms is likely to be conflicted by virtue of audit or other consulting work. It is, in fact, these conflicts which has caused a general movement of practitioners from Big 4 firms to larger specialist insolvency firms. However, the choice of firms who can perform a larger assignment is quite small. The behaviour of firms since the removal of IPAA rates has reflected this – there is really no price competition in the industry.

Secured creditor incentives

Although most executory assignments in Australia are now commenced by the directors (in particular voluntary administration), this is not a proper reflection of reality. In almost all cases, the secured creditor is highly involved in the period leading up to the insolvency. Most directors 'jump' before they are 'pushed', but there is no question that most directors 'jump' because they are given advice that if they do not, the secured creditor will act anyway. Taking the decision gives the directors choice of the IP, but only up to a point. If the secured creditor does not agree they have the right to appoint a Receiver which negates the purpose of the voluntary administration. Therefore, the choice of IP is limited by what the secured creditor will accept. A Director may be incentivised to chose a practitioner who is cheaper, as it may well be their money in question. But the secured creditor is incentivised by which firm will do the best job for them.

This raises the question as to the incentive of the secured creditors. In fact, they are delighted that directors now often appoint voluntary administrators since it avoids them having to incur the bad publicity of doing it themselves. However, they want an IP who basically realises that they are working for the secured creditor first and foremost. Therefore, they tend to prefer the larger firms for whom, of course, they are a major source of work. There is an inherent conflict of interest – firms realise that secured creditors are their major work providers and in some cases (such as Big 4 firms) their major clients in other areas.

In relation to fees, it was my experience that there was one very clear rule. If the secured creditor got their money back, they simply did not care how much the IP charged (unless it was obviously indefensible). If the bank was faced with a shortfall, they cared quite a lot. It was common for the major banks to agree to pay full firm rates if they expected to be repaid in full, and ask for some discount when they did not. Although I understand that this approach has become far less common (mainly due to the obvious conflict of interest generated) it does accurately demonstrate the incentives involved.

Who is actually paying?

In a case where a secured creditor expects to recover their debt in full, the 'cost' of the insolvency is basically being paid by the unsecured creditors (who, of course, have been prejudiced already by the ability of the bank to invoke a floating charge) since the fees have reduced the surplus of assets available to pay them. By the time the surplus has been paid to a liquidator, there is basically no chance that the fees of the Receivership can be challenged.

However, it also has to be remembered that banks usually hold personal guarantees from directors (or, often, security over their other assets such as personal residences). If the bank does make a shortfall in an insolvency administration, they are entitled to seek to recover it from the directors. Since IP costs are charged to the administration, these costs are simply being passed onto the guarantor in the case of a shortfall. Again, the bank has very little incentive to be genuinely concerned about the level of fees, and the guarantors have virtually no rights to object to what has already been paid.

Therefore, the only cases in which secured creditors really care about the level of fees is when they will not get repaid in full and when they will not recover the shortfall from guarantees and other security – eg basically, when the bank has screwed up. Most of the time, they are not really paying.

Banks and IP fees in practice

In most cases, secured creditors now insist on some 'discount' on firm rates. This discounting represents opportunism, not a genuine free market in rates, and is done mainly to set the bar lower for fees charged on non-executory (eg advisory) assignments. This is because it is important to note that *even by changing the hourly rates the secured creditor has no control over the actual cost of the assignment.*

Insolvency fee are calculated on an hourly rate. If the secured creditor does restrict the hourly rate, the IPs show an 'under-recovery' in their accounts. They are simply incentivised to be less efficient and take a larger number of hours to do the work. In my experience, not even an experienced secured creditor has any real control over the efficiency of an insolvency assignment. Therefore, the best they can do is to bargain a bit 'to make a point'.

A further problem then arises in director-appointed Voluntary Administrations. If a 'major' firm is appointed banks will often decline to appoint a Receiver if they feel the IP can be trusted. However, their bargaining power over rates is also lost. Typically, IPs charge full 'firm rates' in a VA and if there is a bank in place they will usually accept this, as the discount which they may have negotiated if they had appointed a Receiver is certainly not significant enough to change their behaviour. Of course, if the banks were incentivised by fees one would expect them to appoint Receivers all the time over the top of VAs, as they could get the work done cheaper. In fact, their behaviour is confirmation that they actually rate bad publicity significantly higher than IP costs.

IPs are able to credibly charge their full rates on the basis that 'these are the rates that we charge for this type of work'. The structure of the voluntary administration process (as noted below) means that it is highly unlikely that creditors will actually remove a practitioner because of cost.

Staffing of banks

It is well established that Judges are generally not driven to control legal fees because they were usually recruited from the ranks of lawyers. In fact, many staff at the 'insolvency' departments of major banks are recruited from IPs. They have a similar disincentive to really address IP costs.

Summary

In summary, the issues are:

- Despite the appearance of director control, in any case where there is a secured creditor they are the most important party in determining the choice of the IP (either as VA or Receiver appointed 'over the top').
- However, secured creditors have NO incentive to control IP fees when they believe that the security will repay their debt or they have access to guarantees. Although they usually insist on some sort of discount for Receivership work, it is obviously not a major driver of their behaviour as they tend to be happy to 'pay' full rates in director-appointed VAs.
- It is almost impossible for a Liquidator to challenge the fees of a Receiver or VA after the event, and in any event they would be acting against their own long term interests by doing so.
- Most fee negotiations between secured creditors and IPs are symbolic rather than real because changing the hourly rates does not necessarily have any actual effect on the cost of the insolvency. Secured creditors cannot judge efficiency.
- In a voluntary administration setting, at the time of the first meeting of creditors the IP has been in place for 5 days. Although in theory creditors could vote to replace him due to the level of his fees, this assumes:
    - That a 'normal' trade creditor even knows a competing IP and can take the time and effort to get him to the meeting.
    - That the competing IP will actually be cheaper.
    - That the secured creditor would accept the competing IP, which they are not incentivised to do, having usually approved of the IP already in place.
    - That the creditors will consider the value of the saving greater than the duplication of work required for a new IP to take over 5 days into an assignment.
- In cases where there is no secured creditor, it is easy for IPs to claim their normal rates by claiming that this is what they are routinely paid.

In summary, there is no free market in IP fees levels. Before I address how this might be remedied, the 'other' part of the equation needs to be considered.

IP EFFICIENCY

Accountants and IPs

IPs originally emerged from traditional accounting practices. These practices employed qualified accountants and accountants undergoing qualification. Their fee structures were always hourly for both tax and audit work and the insolvency divisions simply followed the same procedure.

However, IP work is fundamentally different. All audit, consulting and tax work can be quoted based on hourly rates, but it is never open ended. A firm will have a reasonable expectation of the number of hours required to do the work. The scope will be determinable. The client will ask for a quote and can then negotiate on the total figure. If the standard rates suggest the job will cost $100k but the client will pay only $80k, the firm has an incentive to be efficient – eg do the work in less hours. Although there is always 'out of scope' work most audits and consulting assignments either have a fixed fee or at the very least an accurate estimate of total cost based on hourly rates. Firms have large computerised systems that break down audit work into individual timed tasks which they can use as a basis of a quote.

None of this applies in insolvency. It is genuinely impossible to estimate the hours of an assignment before it is commenced. *However, it is important to realise that this situation is unique* amongst professionals who charge on an hourly rate. Lawyers are also generally able to determine the estimated time for each task on which they are engaged.

The incentives provided by this are obvious – IPs are incentivised to be as *inefficient* as they can get away with. The more hours they spend, the higher the fee.

Actual IP behaviour

It is totally unrealistic to accept as a solution to this issue that 'IPs are professionals and would not behave like this.' In fact, I do not believe that the inefficiency is necessarily deliberate. However, without any incentives to be efficient they have developed methods of business that are not driven by market forces but by their own convenience. The outcome is quite as expected by the incentive.

In my own experience, IPs are very inefficient. The details would be voluminous, but in summary:

1. They tend to use professional staff for almost all roles, even when they could just as easily be done by non-professionals. This is because firms of accountants generally are staffed primarily by professional staff and IPs are no different.

2. There is no incentive for IPs to use non-professional staff for less challenging work. In fact, they are incentivised to do the opposite.
3. When non-professionals are used, they are still charged at very high hourly rates, far above what would be considered reasonable based on the actual roles being performed.
4. IPs tend to promote staff as quickly as possible, regardless of their ability, since each promotion increases hourly rates. The vast majority of staff automatically promote every year.
5. IPs are incentivised to have the work done at the highest level of staff rather than the lowest, since the rates are higher.
6. Most IPs do not have a large number of staff. Jobs are staffed largely by who is available. If (say) a Manager is available but the role actually requires an Assistant Manager, the person will always be charged based on their grade, not the role. In fact, the roles of the different grades are hugely vague.
7. Since efficiency is not important, it is very common to staff assignments with staff who do not have sufficient experience. This was very common in the Big 4, where non-insolvency staff were routinely placed on insolvency assignments when there were no other staff available. They would still be charged at their normal rates.
8. Training and systems are less important because it is acceptable for staff to 'learn on the job'. If a new recruit is inefficient the hours actually worked will be charged in any event. Generally, new staff are trained at the expense of clients.
9. Inefficient systems are retained, especially when it 'suits' the IP. For example, many firms require all payments (of whatever size) on any insolvency to be signed by the Appointee. IPs claim that this meets regulatory rules. However, the actual effect is that the creditors are paying $500 or more per hour for the Appointee to act as an accounts payable clerk. It is easy for IPs to defend these practices (and the additional regulations proposed under the Options Paper will make this worse). Many firms require all correspondence to be signed by the Appointee, even on trivial matters. Again, this is totally inefficient but IPs feel it is supported by regulation.

Recording of time

However, the main issue is how hours are recorded. IPs tend to claim the process is similar to that of lawyers. This is untrue. Lawyers generally work on a 'real' time clock, and charge specific tasks in six-minute units until they have finished. When they move to any other task, the clock is stopped. This is not the case with IPs. Nobody has an actual 'clock'. In ongoing assignments, staff will work for chunks of the day, whole days, or even weeks or months charging all the time to the job. If they are interrupted, take a break, work inefficiently, re-do work, have computer or system problems, engage in administration or any other pursuit, the time is often charged just the same. Many times I was present when professional staff together costing thousands of dollars per hour were engaged in stuffing reports into envelopes for a circular to creditors. Very limited records are kept of time spent and mostly

they are a few notes at the end of each day. There is virtually no monitoring of time charged – if a staff member is working on an ongoing assignment and takes a two hour lunch break, they can charge the whole day to the client and there would never be any way in which this could be proved or disproved later. The only time an IP would have cause for concern about the amount of time being charged by staff is if he is having trouble recovering those fees. As long as there is money in the administration (and particularly if the secured creditor looks like getting repaid), nobody has any incentive to care. The only actual limitations on fees are:

- Are there enough assets in the administration to pay the fees?
- Will the Committee of Inspection (or secured creditor) approve them? As noted below, this is usually purely a theoretical issue.

In summary, the key problem is that time based fees are considered acceptable because they are used by other lawyers and accountants. But for IPs, the application is totally different. IPs, being accountants, simply assume that it is perfectly normal for them to be able to charge premium hourly rates and recover them. However, in fact this is simply a reflection of the lack of market forces at play. The question is whether IPs should expect to be as profitable as auditors, tax advisers and lawyers. Does the nature of the work justify these levels of profitability?

COMPLEXITY OF INSOLVENCY ASSIGNMENTS

The Options Paper seemed to conclude the insolvency was inherently a highly complex process. However, this needs to be examined.

Without question, major insolvencies (such as Ansett) are highly complex in certain factors. However, the actual process being followed in executory assignments is almost always the same:

- Try and sell the business
- If you cannot sell the business, sell the assets.

The major decision to be made is whether the business can continue to trade under external administration. If not, the assets are almost always sold. If it can, the business is usually offered for sale. Sometimes an attempt is made to compromise claims and continue the business. But the fundamental process is usually the same.

However, the vast majority of the process is actually administrative. The business has to pass to the control of the IP. Due to the regulations, all existing functions (especially anything to do with cash and accounting) is taken over by the IP staff. To a large extent in a trading administration, professional accountants are dealing with accounts payable and receivable and employee and payroll issues, not typically roles that we would expect to require staff charging hundreds of dollars an hour. In fact, it is the regulatory requirements which

cause IPs to duplicate functions that have been happily fulfilled by the company staff for years, and at far lower cost.

The strategic decisions, of course, are critical. Nobody would argue that they should not be taken by the appointee or senior staff. However, no more than 20% of the time on any executory assignment would fall into this category.

For the 'average' size voluntary administration, it is not the case that the majority of the work is highly complex. It is actually the dislocation caused to existing procedures of the company by the appointment which is the cause of much of the work. Most of the work is administrative in nature and certainly does not require the attention of qualified accountants. The sale of business can sometimes be complex, but in reality most IPs simply advertise, create a brief Information Memorandum, assess offers and then ask their lawyers to deal with contract issues. Commercial agents sell businesses all the time, but for a fraction of the costs incurred by most IPs. The use of professional accountants for virtually all aspects of an executory assignment is not at all necessary.

International comparison

However, apart from the lack of fee incentives, the major incentive that causes IPs to proceed in this way is regulation. The more onerous the regulations, the more they feel the need to 'cover their backs'. Accordingly, Appointees are usually heavily involved in every part of the assignment. In this respect, Australia stands in stark contrast to the UK. In even relatively large UK insolvencies, the Appointee will spend very little time on the job. They attend only to strategic matters and client relations and delegate virtually everything else to the job manager. In Australia, Partners/Appointees are far more heavily involved. To the degree that I was able to understand why this was the case, Partners tended to quote regulations. Liquidation regulations in Australia are already very onerous, requiring Appointees to personally approve almost everything. Although these rules do not technically apply to other insolvency forms, most IPs feel obliged to follow them. In a UK insolvency, the job Manager would sign almost all correspondence and approve expenditure (below a certain figure, but GBP10,000 per transaction was typical) without reference to the Appointee. In Australia, work is pushed 'up' the pyramid, not down.

Summary

In summary, insolvency is an unusual mix of highly specialist strategic work and a large amount of routine administration. However, due to their history and market conditions, and the impact of regulation, all this work is being done at very high professional hourly rates. There is a huge difference between the strategic work on say Ansett and a typical trading voluntary administration. At present, they are basically treated the same from a cost point of view. The only difference is that one takes more hours than the other.

COMMITTEES OF INSPECTION/CREDITORS

In cases where there is no secured creditor, IP fees are usually approved by the Committee of Creditors/Inspection (CoI). This appears to make sense. It is only when you see it in practice you realise it is impossible.

The Options Paper correctly analyses the many reasons why CoI's are unable to make informed decisions on IP fees. However, it does not provide any real solutions. It also ignores the key factor in most actual cases – apathy.

Creditor apathy

The VA process is designed to allow unsecured creditors to let off steam – the first meeting has basically no other purpose. However, by the time of the second meeting most creditors have realised that it will be many years before they receive even a small portion of their money, if ever. If a liquidation follows, the major challenge is usually even finding enough members to form a CoI.

IPs are well aware of this and use it to their advantage. Advance fee approvals and fee caps are all just methods to get the CoI to approve their fees whilst they are still interested. But ultimately, CoI's have no real options:

- As noted above, the first meeting in a VA is really the only time that creditors could realistically swap an IP for someone who is offering lower fees, even if that existed. By the time of the second meeting, the IP is too involved in the case and the creditors will always be made to feel that any change is just going to cost them more due to the time it will take to handover the case.
- As noted in the Options Paper, CoI's do not have any of the skills or experience to manage an IPs fees. Secured creditors who deal with IPs all the time are mostly 'fee-takers' – it is totally unrealistic to expect CoIs to actually control the process.
- Ultimately, if the CoI refuse (or are not able) to approve the fees, the IP will simply go to Court. Courts are in no better position to judge and will generally approve fees unless there is a major objection. Therefore, for the CoI to reject fees is usually self-defeating.
- As noted below, a lot of liquidations involve liquidators funding fees via recoveries of voidable transactions. In these cases, large fees can accrue that cannot be paid for some time. CoI's routinely approve these as, basically, it means nothing to them. Of course, if recoveries are made, the fees have already been approved.

Summary

In summary, asking creditors to monitor and approve IP fees is both unrealistic and actually unfair to them. There is simply no way that they can actually fulfil this function. In reality, they are just a rubber stamp. IPs can continue to be inefficient and charge excessive hourly rates and there is fundamentally nobody who can really hold them to account in a liquidation. If the Government wishes

creditors to actually control fees for IPs, it needs to give them adequate tools and resources to do the job.

INCENTIVES FOR IP MISCONDUCT

Court appointed liquidations

In the UK, Court-ordered liquidations are referred to the Official Receiver, a Government department. In the unlikely event that there are any significant assets with which to deal, the liquidation may be passed to a private IP. However, most cases are closed by the Official Receiver without any further involvement from the profession.

In Australia, Court-ordered liquidations are handed to Official Liquidators on a rotational basis. There is considered to be some 'credibility' attached to being an Official Liquidator, and in any event only Official Liquidators can take certain types of appointment (Provisional Liquidations). Therefore, many IPs become Official Liquidators and in return receive a regular supply of asset-less cases on the off-chance that once in a while a 'real' case will result.

These cases, called 'Court-dogs', need consideration. Why would IPs agree to wind up companies, basically for free? It would surely make more sense for them to request that the Government set up its own department and do its own dirty work, as in the UK.

VAs and Receivers

The advent of the Voluntary Administration also saw another angle to this practice. In many cases, both a Voluntary Administrator (VA) AND a Receiver and Manager are appointed to the same company. In these cases, the Receiver gets access to the assets. In most cases, the VA is asset-less and the company usually proceeds into liquidation. Originally it was typical for a VA to be appointed first and the secured creditor may then choose to appoint a Receiver 'over the top', leaving the VA in place and continuing but with no assets. However, more recently IPs are accepting appointments as VAs when there is *already* a Receiver in place, guaranteeing themselves an asset-less administration. Why?

Voidable transactions

The reason is in the actions available under the Corporations Act available to Liquidators. Although these were evidently designed to assist creditors and were modelled on similar provisions in other jurisdictions, it is the actual detail of how the Australian Corporations Act works that has a profound and, in my view, highly negative effect on the insolvency profession.

Although there are others, the main provisions are S588FA Unfair Preferences and S588G Insolvent Trading. Basically, these actions are available to Liquidators only and are aimed at recovering money for unsecured creditors. As most

unsecured creditors have very little chance of a dividend in the case where there is a secured creditor, creditors have every incentive to encourage IPs to start these causes of action. There are however two issues:

- These claims are very expensive and cumbersome to make (moreso Insolvent Trading)
- There are often no assets available to Liquidators to run these actions. Either they must get funds (from creditors), do it 'on spec' and hope that they get a recovery later from which to pay their fees, or get litigation funding.

Unfair preferences in practice

In principal, it seems reasonable for claims that might result in a recovery to be pursued. However, the issue is with the exact operation of S588FA. The concept is that if a company pays one creditor prior to an insolvency, it is 'unfair' on the other creditors and the money should be returned to the Liquidator and shared amongst all creditors. However, the position is not that simple:

- The Government is apparently quite happy to allow banks, who have full access to a company's financial position and management and therefore has more knowledge than any unsecured creditor as to the future prospects of a company to jump the queue by reason of a floating charge. However, if a creditor (who has very little access to any information and no way of securing their interest) tries to quite reasonably get paid, this is 'unfair'. Many would consider that it is perfectly reasonable for a creditor to get their money if they can.
- The UK equivalent of this clause requires that the payment be genuinely unfair – eg *that the payment was being made to defeat other creditors.* This is NOT the case in Australia. In Australia, the presumption is made that any payments received were preferences *unless* "the person had no reasonable grounds for suspecting that the company was insolvent at that time or would become insolvent ..... and a reasonable person in the person's circumstances would have had no such grounds for so suspecting."
- The Courts have held that if a creditor is having continual trouble getting paid, then it is likely that "reasonable person" would suspect they were insolvent. This goes so far that if you get a round sum payment against an overall debt (eg the company does not pay a specific invoice) it is pretty much taken as *prima facie* evidence of knowledge of insolvency. Basically, if you are having trouble getting your money back, you are not allowed to chase it because to do so you might suspect they are insolvent.
- The difference between the UK position and Australia is crucial – here, a genuine attempt to get paid a debt which is overdue (a perfectly reasonable action in most people's eyes) can be a preference because a "reasonable person" might suspect that the company is not paying within terms because it might be insolvent. In the UK, there has to be the intent to create a preference. It is a completely different test. In the UK, unfair preference claims are not that common. In Australia, almost every

Liquidator will have a go at making claims against somebody in almost all cases.

Why is this a problem? Because Liquidators consistently use the Unfair Preferences provision to accumulate funds into their (otherwise asset-less) administrations. These recoveries are not available to secured creditors. However, they can be used to pay Liquidator's fees.

The best description of Unfair Preferences is legalised extortion. At the start of every liquidation, the IP goes through all payments made by the company in the six months prior to appointment. They then send demand letters to all recipients of large amounts. There is no equity involved – recipients of smaller amounts are ignored. Basically, Liquidators threaten all major recipients with Court actions under S588FA. There is basically always a chance for the Liquidator in such an action – all he has to do is show that some hypothetical person may have concluded that the company's delays in paying meant they were insolvent. In almost all cases, the only purpose of the Liquidator is to force a settlement from enough creditors to fund their administration (and, hopefully, show a small return to creditors to justify the operation).

Bad law

The process is fundamentally unfair. It is not a matter of the Liquidator recovering company assets – it is a process of forcing creditors who have behaved quite reasonably to give back money to a Liquidator primarily to cover their fees. *If the Government genuinely believed this was reasonable, it would amend the Corporations Act to allow Liquidators to automatically recover ALL payments received by creditors in the six months prior to the insolvency, and then share the total proceeds back between all creditors.* The current process is arbitrary, unjust and serves no genuine purpose.

It has been allowed to continue since the effect is to persuade IPs that it is worth taking asset-less (Court) cases for free because they always have the chance to recover a preference. Basically, it is saving the Government from its duty to create a body to deal with these matters itself.

This is a classic example of 'bad law' – a law which is fundamentally flawed but allowed to continue because it is convenient. However, apart from the equity issues, it also effects the entire structure of the profession.

Implications

The fundamental issue is that this encourages the worst kind of IP. In these types of cases, the recoveries of Unfair Preferences usually will only produce a return of a few cents, at best, to unsecured creditors. However, creditors have no reason to oppose this behaviour – they stand to get nothing anyway. But creditors are fundamentally disinterested in the proceedings. It becomes carte-blanche for the Liquidator to accumulate fees without any realistic prospect of oversight.

Most of the actual problems with IPs come in these circumstances. There are whole firms (and groups within firms) who exist to take asset-less jobs and recover preferences. They are subject to no realistic oversight – their biggest challenge is to persuade enough members of the Committee of Inspection to show up to approve their fees. In these types of case, usually the creditors have totally lost interest by the time that recoveries have been made.

These cases have become favourites of litigation funders. This is purely because the law is so biased that the chances of a recovery are so strong. Ultimately, IPs, litigation funders and insolvency lawyers are being given free reign to create fees and then force creditors to pay them. It is a self-perpetuating industry and creditors are not in any way the focus of these efforts.

Changing the Unfair Preference laws (to something more akin to the UK law) would change the Australian insolvency profession overnight. Much of the self-serving behaviour of IPs results in cases where they are using the pretext of recovering funds for creditors but instead generating fees and then finding assets to pay them.

Behavioural effect of reform

Changing the unfair preference law would also take care of many of the worst practitioners. Without being able to exploit asset-less appointments in this way, these IPs would have to move back to the mainstream where their work is genuine and accountable (at least to a greater extent). Instead of dragging out corporate insolvencies for years with endless claims, most could be finished more quickly with the actual assets realised and distributed and the case closed. *The fact is that in a corporate insolvency, most unsecured creditors are going to lose all their money.* There is no way around this (short of eliminating the floating charge) and dragging the process out in hope that some small recovery might one day result is not actually in the best interests of creditors or public policy.

Many of the actual cases of IP misconduct involve these types of scenario. Creating an entire business which is split between parties who stand to gain (the insolvency professionals and funders) but which can probably only result in minor returns to creditors after many years is an obvious candidate for abuse. The ratio of fees incurred to recoveries in these cases is usually horrific. But despite a few scathing comments by Judges, the practice continues, justified by the argument that any recovery (even one as illusionary as unfair preferences) is better than none.

Double appointments

The process of having both a VA and Receiver and Manager appointed to the same company is, and always has been, pointless and wasteful. Once the chance of collecting preferences is withdrawn, there is seldom anything for the VA/Liquidator to do unless there is a surplus from the Receivership. It would be far better to save the duplicated and self-serving efforts by automatically suspending a VA when a Receiver is appointed. If a liquidator is later required,

one can be appointed by the Court (or, as happens in the UK, the Official Receiver is appointed).

Insolvent trading is a separate but important matter. This is, in many ways, a 'fair' claim for a Liquidator to make. However, the process for proving Insolvent Trading is so cumbersome as to be inpractical. Once again, the complexity and cost involved inevitably lead to the same trap – Liquidators spending years pursuing claims with virtually no oversight or interest from creditors, but when creditors have no incentive or reason to bring an end to these proceedings. When funds are recovered in these situations the creditors are receiving something compared to nothing, so are in no position to actually control (in any real way) the fees that have been incurred. From their point of view, they simply have no other options.

Of course, often the main factor is whether the Liquidator has recovered enough from Unfair Preferences to fund an action against the directors. The reason we are seeing many IPs take VA appointments where a Receiver is already appointed is that it is all a very lucrative business. They will usually become the liquidators, where they can engage in preference recoveries (often with their fees funded by litigation funders) which will then be used to pay all the fees they incurred as VAs. If (as usual) the amount recovered would only present creditors with a few cents dividend, it is usually pretty easy to persuade creditors to let them spend more time and money pursuing the directors. The job will end up running for years, with the collective fees of the IP and the lawyers completely out of proportion to the outcome to creditors or, frankly, any public interest.

With respect, none of the regulatory options raised in the Options Paper are going to address this sad underbelly of the insolvency world.

Summary

The solution in the case of unfair preferences is to change the law. The solution in the case of Insolvent Trading would be to substantially streamline how these cases are handled by the Courts. If the Government genuinely desires directors to routinely be held liable when their companies collapse, they need to make the bringing of these actions a practical and economic proposition. At present, the enforcement is random and inequitable, dependent not on the degree of culpability of the directors but simply how deep their pockets might be and the chances of forcing a settlement. None of this is good public policy and in the long run it does not advance the interests of creditors as a whole. Since IPs can charge and earn large amounts of fees in these circumstances, they will of course be able to justify equally large fees when there are in fact assets available for distribution to creditors.

RECOMMENDATIONS

The recommendations offered in the Options Paper will not, in my opinion, lead to any significant change in the industry. They are nowhere near radical enough

and critically do not address any of the incentives that currently make people behave the way that they do. I would make the following suggestions:

Insolvency Fees Assessor (IPA)

It has to be understood that IPs are almost unique in professional circles in being able to charge premium hourly rates on open ended assignments. Therefore, it is perfectly reasonable that far more rigorous rules should attach to hourly rate charging in these circumstances:

1. The Government should form an independent body, the Insolvency Fees Assessor (IFA).
2. This body (probably under the auspices of ASIC) would be an independent body for the assessment and approval of fees in executory insolvency assignments.
3. Creditors will have a choice between using existing procedures (eg approvals by CoI's) or using the IFA to monitor and approve fees. It would be a requirement for creditors to be offered the option of the IFA in all cases. Once a case is placed with the IFA, creditors lose their rights to approve fees unless they vote to remove the IFA.
4. The IFA can be funded in two ways. Firstly, a general levy on all IPs (possibly a percentage of fee revenue). Secondly, a fee for service basis – a schedule fee charged to the assets of the insolvency administration involved. The IFA would be bound to agree to act to monitor fees in asset-less administrations but their fees would be paid prior to the IP fees when any assets are recovered. I would suggest a combination of the two as the fees for engaging the IFA in each case must be kept as reasonable as possible.
5. For secured creditor appointments, the IFA must *always* be used. This is necessary because, as noted, there is no incentive for secured creditors to control fees when they are likely to receive the debt in full. It is not realistically possible for the IFA to review Receiver's fees after the event on behalf of a Liquidation.
6. Hourly rates MUST be set by the creditors, not the IFA, although the creditors may ask the IFA to advise them on what rates would be appropriate given the complexity of the assignment. If the IFA negotiate rates on behalf of creditors it will lead to a repeat of the IPAA rates situation where a scale of rates is being imposed. The role of the IFA should be to ensure that the hours being charged are reasonable and properly substantiated and to monitor efficiency.
7. The IFA will act on behalf of the creditors, but once appointed become the sole approval body for fees. Their role would be:
    a. For each phase of the assignment, assess the work involved and agree with the IP a budget of fees and expenses.
    b. To monitor fees and expenses and approve changes to the budget.
    c. To set and enforce reporting standards for time recording and ensure that proper evidence is provided to substantiate the work performed.

d. *Critically, the IFA will have the right to attend any IP at any time and observe and investigate the conduct of the assignment.* They will be able to check efficiency, that work is being conducted at the correct grade and using the correct type of staff and that time reporting procedures are in place and being followed.
e. The IFA can elect to approve, reject or modify fees based on their investigations. This will happen every three months on each assignment.
f. The IFA shall have the power to make suggestions to individual firms or the industry as a whole on policies and procedures which they feel are appropriate to improve efficiency and accountability.
g. The IFA shall report to CoIs if requested although the CoI cannot direct the IFA in its decisions once they have been appointed. The IFA may call a meeting of creditors or the CoI and report on any issues that they feel should be bought to their attention.
h. CoIs would have the power to terminate the role of the IFA at any stage and take back approval rights. However, the IFA would remain able to decide on all fees incurred prior to their termination.
i. IPs would retain the right to appeal the decisions of the IFA to the Courts and ask for approval of fees that have been denied. Obviously, they would need to show cause as to why the decision of the IFA was unreasonable.

Over time, the IFA would become experts in determining and controlling IP fees in a way that creditors can never achieve. Their 'on the ground' powers to observe the conduct of assignments underway will help them drive efficiencies throughout the industry. If, as IPs claim, all their time spent is properly recorded, efficiently used and reasonable, IPs should have no objection to the IFA.

This reform would, in all likelihood, have a significant effect on IP fees. Firms would be very reluctant to continue inefficient practices knowing that the IFA have the ability to investigate on the ground, review their files and ensure that all time is being properly spent. It would also mean that fees are generally being approved by a body with sufficient expertise to take on this function. As noted, creditors (other than secured creditors) would not be forced to use the IFA but it is highly likely that most would choose to do so.

Voidable transactions

1. The text of the Corporations Act relating to unfair preferences should be changed to make clear that a transaction is only an unfair preference if either the company or the creditor intended that the transaction would be to defeat other creditors and create a preference.
2. Public Examinations are a tool available to Liquidators who are considering starting actions to recover voidable transactions, and very often Insolvent Trading cases. Although in principal the holding of an examination is straightforward, because it requires the approval of the Court and takes place in a Courtroom, most IPs feel the need to use legal

advisers to actually ask the questions. As a result, most public examinations are actually quite expensive to hold.
IPs should be given a cheaper and simpler alternative – a formal deposition. The IP should have the power to summon a person for a deposition directly without the need for Court approval. This can take place outside of a Courtroom and at the office of the IP. The witness will be answering under oath (as with any deposition) and a court reporter used. However, the IP would ask the questions directly. Obviously, if the witness refuses to answer or co-operate the IP would have the option of asking the Court to force them to appear at an examination. However, a formal deposition process would be far cheaper and quicker than the present public examination route.

3. Serious consideration needs to be given to Insolvent Trading cases and how they proceed. Because the standard is judgemental, both sides are usually going to be advised that they have a case worth pursuing or defending. As a result, these case simply take far too long and cost far too much to bring. The directors that do have judgements made against them are not usually the most culpable and many culpable directors escape because the costs of the actions are not economical in that case.
These cases tend to involve endless experts reports and take years to resolve. Even the liquidator is obliged to get an independent report to establish solvency, even though they are perfectly qualified to judge this themselves. Procedures need to be streamlined so that these cases can be bought to Court quickly. Specialist insolvency Judges are probably a key part of the solution and it is possible that ASIC may need to review all such cases at some level to ensure consistency and appropriate use of resources.
4. One item not mentioned previously but in need of reform is floating charges that were registered within six months of an insolvency. These charges are void against a Liquidator, although exceptions exist. However, it is usually not possible to prevent a Receiver from being appointed under such a charge, and tactically many secured creditors will make appointments under newly registered charges and consider that they are in a strategically better position as against an unfunded Liquidator.
It would be far more reasonable if it were not allowable to appoint a Receiver under a charge that was less than six months old. The secured creditor may still claim priority in a Liquidation (for example on the basis of new monies advanced) but this should be a claim for them to make in the Liquidation.

IP Efficiency

1. Much of the cost in the early days of a trading executory assignment is caused by the effect of regulations which must be followed by the IP, particularly the closing of existing bank accounts which causes huge disruption and causes much expenditure of time by professional staff on basically clerical matters. I would therefore suggest:

a. Laws and procedures are introduced that allow the IP to maintain the current bank accounts but with a fixed cutoff after the time of their appointment.
b. IPs automatically and by law should gain the authority to sign or authorise on any account operated by the company after their appointment.
c. Banks operating accounts, together with all other parties, should have NO rights of setoff against any balance in the account at the time of appointment, or ANY funds deposited into the account thereafter.
d. If a payment is made from such an account by mistake after appointment, the bank and the IP will have automatic powers to recover these payments as a matter of right. Again, no rights of setoff or retention can apply in these cases.
e. Banks would be required to continue the operation of accounts (in the same way that utilities are required to supply an IP).
f. The Government should work with the banks to address the administrative issues involved so that proper separation of accounts can continue without the huge disruption that follows automatic closure of accounts.
g. Secured creditors making appointments would not be able to insist that Receiver's accounts are held at their own bank. They should be protected by legislation from any claims being made upon the old account in respect of funds recovered during the administration.
h. IPs should be given latitude to authorise their staff to make commitments and payments in an insolvency administration including Liquidations, in relation to general trading expenses.

2. The other hugely inefficient area is employee entitlements. Almost all insolvencies with trading involve complex and time consuming calculation and payment of employee entitlements. Although some IPs have staff that specialise in this to some degree, it very often involves large amounts of professional time (and usually a lot of 'learning on the job'). Much of this work is clerical in nature but charged at hundreds of dollars per hour. It is likely that a large sum of fees in relation to Ansett were actually in relation to calculating and distributing employee entitlements. I would suggest:
    a. The Government set up a national Insolvency Employee Administration Office (IEAO).
    b. The IEAO will specialise in the calculation and payment of employee entitlements.
    c. IPs will be required to use the IEAO unless they can show that they would be able to do the work cheaper themselves, or that other circumstances warrant this approach.
    d. IEAO fees would be paid by the IP from the assets of the company parri-passu to their own fees.
    e. The IPs role would be simply to collect and send the employee records of the company to the IEAO at the start of the insolvency and to access and pass any additional records that are required in

due course. IEAO staff would then be able to develop efficient and specialist systems for calculating entitlements and communicating with employees to confirm their claims. IP systems for dealing with these issues lack economies of scale and are therefore largely manual.

f. If there are any disputes in proving debts, the Liquidator would make the determination as at present and advise IEAO of the outcome. The IEAO is purely an administrative tool for calculating the claims.
g. Once the IP has assets available for distribution to employees, he would deposit them with the IEAO who would make the physical distributions to individual employees.
h. The IEAO would result in huge efficiencies. As noted, this is basically a clerical job for which systems could be developed by the IEAO. None of the IPs are incentivised to be efficient in dealing with entitlements and thus all this largely clerical work is done at professional rates. Separating the actual administration of employee claims (to be done by the IEAO) from the recovery of assets to pay the claims (to be done by the IP) would be massively more efficient and result in greater recoveries for employees and creditors.

Asset-less liquidations

1. The Government needs to establish an Official Liquidator's Office (OLO) to handle asset-less Court ordered liquidations.
2. Subject to the requested changes to the Unfair Preference laws, the OLO can pass liquidations back to the list of Official Liquidators if their initial enquiries reveal that there are matters which have a reasonable prospect of generating a recovery of assets.

Voluntary Administration and Receivership

1. If a Receiver and Manager is appointed to a company where there is already a VA in place, the VA should automatically be terminated.
2. A VA should only be able to be appointed to a company to which a Receiver and Manager has already been appointed by leave of the Court.
3. In the event that a Liquidator is required, one can be appointed by the Court at a later date on application by a creditor as usual.
4. If the secured creditor believes that any of the options available to a VA would be appropriate, they can always opt to withdraw the Receiver and Manager and appoint a new VA by virtue of their position.
5. These rules should only apply in the case of a Receiver and Manager appointment. Fixed charge receivers do not have the ability to run the operations of a business and therefore can co-exist with a VA.
6. All of these procedures work perfectly well in the UK where an Administration and Receivership environment also exists. The current duplication in Australia is driven by preference recovery laws, not by any actual need.

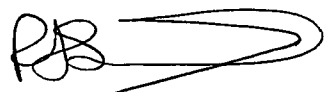
Termination/handover of administrators and liquidators

1. The only time that creditors have a realistic prospect of changing the IP is at the first meeting of creditors of a VA or Liquidation.
2. In any such case, creditors are advised of the cost of transferring the administration from one IP to another. Since the creditors had no initial say in the choice of IP, and the IP is acting on their behalf, this is a clear case where creditors are being unfairly manipulated by the system to confirm the choice of IP that has already been made by the directors/secured creditor or Court.
3. IPs should be required by law, where creditors vote for a change of IP, to handover the case to an incoming IP without charging the administration for the cost of the handover. In addition, incoming IPs should also be required to take the handover without charging for the handover time. The reality is that if creditors are aware of this they are far more likely to insist on their choice of IP and to engage in sensible discussions about fees. IPs stand to make very good money out of assignments and in order to create flexibility of choice for creditors it is not unreasonable that handovers should be performed without charge, especially given that they are usually appointed without prior reference to their actual clients (the creditors).

CONCLUSION

If the Government is to make any actual significant changes to the insolvency profession, the Options Paper will need to be significantly revisited. The focus needs to be far more on practicalities and incentives as opposed to regulation. The recommendations listed above would have the effect of changing the incentives and providing a fair balance between the various interests at stake, including the public interest.

Yours faithfully



Ryan Shaw