REVIEW OF THE INSOLVENT TRADING SAFE HARBOUR

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Executive summary

Objectives

The objective of corporate reform in the 2020s should be to promote productive commercial behaviour, assist otherwise healthy companies to survive short-term setbacks and an insolvency framework supporting the speedy and efficient wind-up of failed and insolvent companies.

The government should be promoting the formation of business capital, influencing the training and behaviour of directors, and enabling the business community to allocate resources in the most efficient way to support the government's national economic objectives. Super funds should be investing capital in growth businesses in Australia to promote jobs and economic growth rather than buying foreign assets and listed shares instead of start-ups

Proposed legislative review

While not perfect the current legislative platforms in place to prevent insolvent trading and enable corporate recovery are largely fit for purpose and require a relatively minimal amount of review to meet the above objective. The problem is not legislative but rather the self-interested conduct of directors and the major creditors.

Ferrier Silvia, a reputable insolvency firm, has summarised the current legislative platforms in a table included on the following page. It is notable that the simplified insolvency reforms for small business have been excluded and I would suggest that debtor in possession models are impractical in their application in the Australian market and should be ignored.

The current shortcomings can be neatly summarised as comprising overlaps, gaps and the absence of a well understood, agreed and coherent framework as to how each component fits together. Each piece of legislation will require review to eliminate needless and costly processes and reporting, as well as incorporating any global developments and best practice local experience.

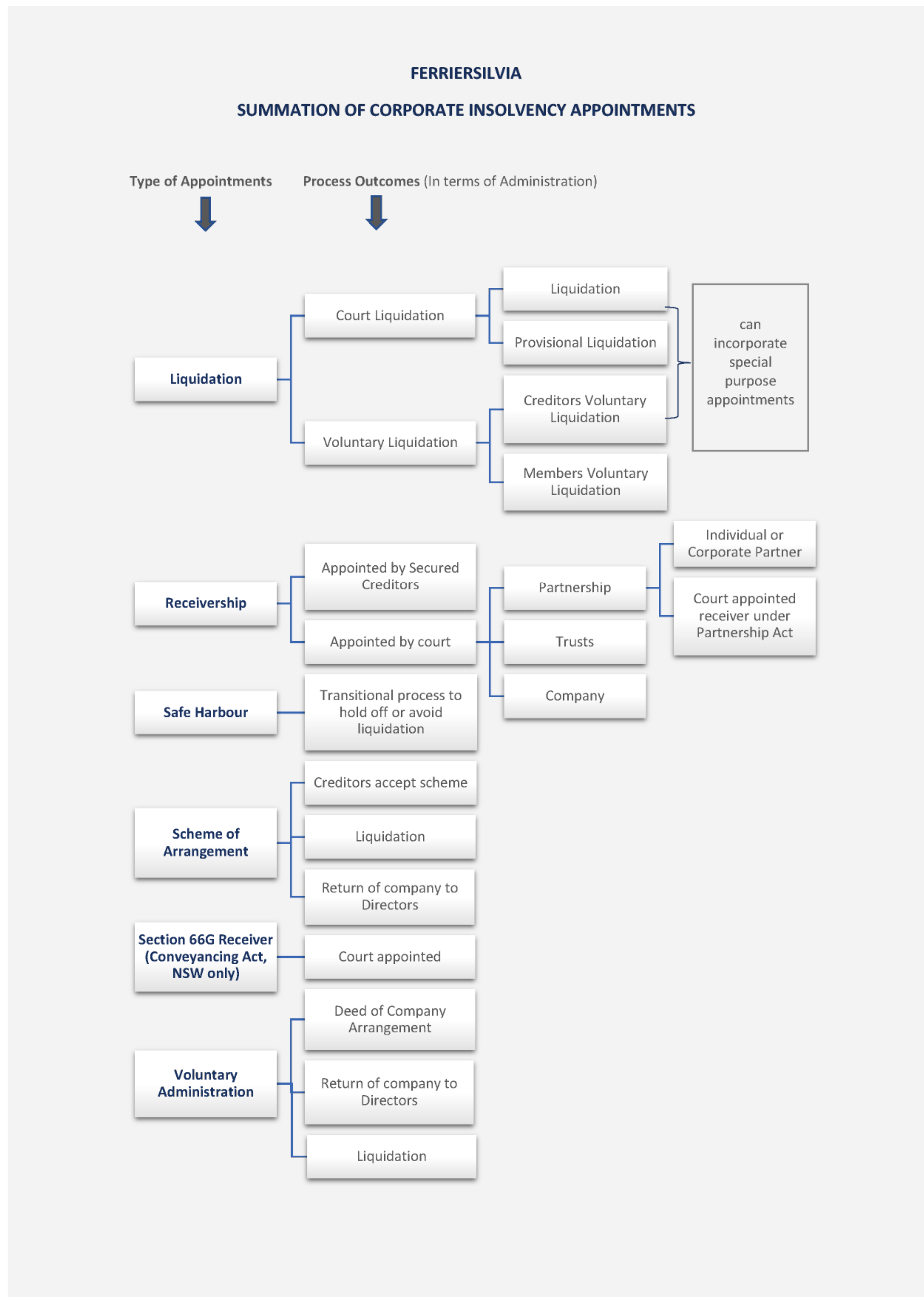
The Safe Harbour provides breathing space for directors to consider the reasons for losses, assess the future viability, and determine the most appropriate legislated insolvency solution.

Safe Harbour Recommendations

The current safe harbour provisions perform a useful function as they provide legislated certainty on how director conduct will be judged where there is potential insolvency. Directors can then focus their attention on turning around their company.

The limitations of the safe harbour provisions are inherent in the legislation, compounded by the conduct of directors and major creditors of failing businesses. Access to safe harbour provisions requires tighter regulation within the current framework.

Ferrier Silvia Summation of Corporate Insolvency Appointments



The view from the coal face – the Facts

There is a considerable difference in perspective on the operation of a mine between a miner underground in Kalgoorlie and an executive in a shiny tower in a faraway city.

I have previously responded to government inquiries in relation to insolvency and banking because, while the problems are usually accurately identified, there is absolutely zero comprehension of the underlying causes and problems. Consequently, without such an understanding, it is impossible to construct workable commercial solutions.

My specialisation in consulting to SME businesses is in the areas of strategy, management, growth, succession, exit and turnaround. I have had lengthy experience in advising and working with SME businesses which were, or were about to become, insolvent. This should not be confused with "pre-insolvency advisers" who are technical experts familiar with enforcement practices who encourage owners and directors to avoid creditor claims on the business.

Businesses fail because they are undercapitalised and poorly managed

Numerous retrospective studies of insolvency administrations have identified a long list of typical warning signs and types of events that have triggered an insolvency. However, a bit like an autopsy, underlying factors, past events, negative behaviours are not identified. It is rare that an insolvent company's problems are not rooted in a lack of capital or poor management.

Conversely a successful turnaround of a failed business will usually require an injection of new capital and new management.

Successful business start-ups will require sufficient capital to cover initial losses and support growth after reaching a breakeven. The alternative is to bootstrap the business which requires a higher level of management expertise and discipline to ensure that the business is profitable and cash flow positive from day one.

The VA regime has not failed

A Voluntary Administrator is supposed to be appointed when a business becomes insolvent and is unable to pay debts when due. Instead, this typically happens when the business runs out of cash and is unable to pay suppliers or wages about two years after initially becoming insolvent.

One of the practical outcomes of a business trading until cash and liquid assets are exhausted is that there is diminished opportunity to 'trade on' or sell the business as a going concern. There will be insufficient funds to provide for a proper administration or material (if any) distribution to creditors.

Directors will never seek early advice

A lot of time and resource in the last few decades has been devoted to trying to encourage the owners and directors of failing businesses to recognise and act on warning signs and seek professional advice. It is believed that this will increase the chances of saving a viable business and avoiding the loss of employment.

No matter how much effort is put in to encouraging owners and directors to seek early professional advice they will mostly continue to ignore the warning signs of failure until they consider insolvency is unavoidable. I have concluded that directors of all sized companies do not want to be scrutinised or made accountable. At all costs.

I expect that under both current and future insolvency frameworks failing companies will continue to trade past the point of insolvency resulting in the destruction of owner and creditor capital, loss of employment and other financial costs to the economy.

Major creditors protect their interests at the expense of unsecured creditors and employees

Major creditors like the ATO and secured financiers ensure that they stay remote from the business and its management to avoid the risk of being deemed shadow directors. However, they have access to management for financial information including forecasts relevant to the repayment of debts.

Prior to the GFC directors might have been forced to act by banks or the ATO where they had

concluded that the company could not recover. Even then this would be at an advanced stage of failure.

Increasingly since then, pressure from media, the government, small business ombudsman, and others combined with their own self-interest has resulted in increasing leniency allowing businesses to trade until they run out of cash.

Current ATO practice would appear to be to continue to negotiate payment plans until such time as the company no longer has cash to meet them. On liquidation the ATO is currently determined to deny repayment of any preferences, and in many cases, there will be insufficient funds for a liquidator to pursue them.

Given low interest rates and booming property values banks, irrespective of the overall financial position of their client, are well covered against loss. Rather than take action and incur the risks and costs of appointing a Receiver there is an advantage in leaving directors to appoint a VA, and maintain their security position over property.

I fully understand their position, but note their special relationships with a failing company, having a high level of access to its management and financial information. There is a loss of efficacy in that while they are able to take action and limit the losses to other creditors and employees, they can instead stand aside and protect their interests ahead of others.

The view from faraway – the Myths

Comprehensive insolvency review is required

There are ongoing calls for review because the Harmer report was completed over 30 years ago. This completely ignores the fact that the conclusions remain valid today because the conduct and interests of the directors of failed businesses has not substantially changed since then.

It is a change in behaviour of directors and major creditors that is required, not dramatic changes in legislation which will have no impact on the consequences of failure and insolvency.

Different legislation will save businesses

Successful restructuring and turnaround are commercial rather than legal issues.

The consultation papers used words and phrases such as:

- enabling company turnaround
- promoting a culture of entrepreneurship and innovation
- facilitating the successful restructure of companies
- survive
- reducing regulatory burden for business
- insolvency reform to help larger companies in distress to reorganise and survive
- companies can benefit from improvements to insolvency law
- simplifying and streamlining insolvency law so that viable businesses that do encounter economic challenges can restructure and go on trading.

Insolvency legislation only enables a stroke of a pen to legally transfer the losses of an insolvent business to its creditors and employees.

Directors wind-up companies prematurely because of insolvent trading penalties

The penalties for trading insolvent are severe, which is not unreasonable given that if a director knows that the company is insolvent, and incurs new debts, it is little different to simple fraud or theft.

However there have been very few successful actions as it can be difficult to conclusively identify a date of insolvency and prove that the directors incurred new debts while they knew the company was insolvent. Action is often not taken because there are no funds available or because the directors have no material assets.

The threat of being liable for trading insolvently has been no deterrent to insolvent trading. Any

thought that some different regime will change this behaviour is fanciful.

Directors of companies of all sizes, and from all backgrounds, fear scrutiny and accountability and will delay appointment of a VA for as long as possible.

I think it would be highly unusual for directors to prematurely appoint an insolvency practitioner. Presumably this would occur where it is in the interests of the company or the directors to do so.

A company will succeed because it has been saved or restructured

It is important to understand that just saving a company does not necessarily benefit employees, creditors, and suppliers. There are significant losses incurred by the company during its period of failure and prior to the appointment of the VA that will never be recouped.

It is unlikely that businesses can be restructured and successfully turned around if there is no new capital, and the same poorly performing managers continue to run the business. There will be little prospect of future growth and it is likely that the business will continue to operate on the edge of solvency. The commercial equivalent of an accident victim remaining indefinitely in a coma.

Rags to riches billionaire entrepreneurs might fail, but they do not blindly trade until they run out of cash, write off their liabilities and just start the same business again.

Small business reform is a successful model

Debtor In Possession models are the insolvency equivalent of the lunatics running the asylum.

Allowing directors to continue to control the company when they have mismanaged it to the point of insolvency is extraordinarily optimistic.

Small business reform as legislated has failed. While the complexity, time and costs have been reduced for owners and directors, those burdens, and the consequent risks, are just passed on to the expert.

The legislation effectively restricts the amount of remuneration that might be paid, and the expert will not be remunerated for their expertise, time and risk assumed.

The Safe Harbour

As legislated, I believe the Safe Harbour regime reflects the intentions of the Harmer review, that if prudent directors identified a potential risk of future insolvency, they would take action to implement plans for recovery. I do not believe the legislation contradicts any legal precedent or commercial common sense and practices.

Due to the confidentiality around Safe Harbour there is little information in the public domain apart from statements from professionals indicating their involvement in these structures, rumours and scuttlebutt. However, none of these contradict the current weaknesses of the regime:

1. Safe Harbour appointments will still be made too late
2. Open ended timeframes
3. No prescription on expertise

Acting too late

Although I do not believe the legislation alters the legal position of directors, it provides reasonable guidance to directors to identify at what point they may be deemed to become liable for trading while insolvent.

At the same time late action will mean continuing stress on the business, and directors may become anxious about their personal liability if an appropriate recovery plan can be put in place. The additional certainty can reassure directors while they formulate and implement short term recovery plans.

Timeframes

Some legal and accounting professionals are actively promoting Safe Harbour as a permanent stay

on insolvent trading, and I suggest that only registered liquidators be appointed as Safe Harbour experts.

These appointments do require multi-disciplinary skills and the liquidator would need to be confident of their own commercial trading expertise as well as employing an appropriate team with operational, financial, and managerial expertise.

SME Companies

With minimal capital, poor management, and inadequate systems it becomes difficult for SME companies to ensure compliance with the minimum requirements to enter Safe Harbour, as well as maintaining eligibility for any length of time.

In my opinion a SME should not be entering Safe Harbour unless there is a plan as to how and when it emerges. Until there is some investigation of failed Safe Harbours there can be no conclusion on this.

Public Companies

I do not believe that listed public company directors should be entitled to any additional protections anticipated by the Safe Harbour review or amendments to the Scheme of Arrangement legislation.

Public company directors enjoy several advantages over their SME counterparts. The company only lists after exhaustive checks and reviews of its plans and forecast performance by expert legal and accounting professionals. They continue to have the benefits of significant shareholder capital, a significant existing business, sophisticated systems, experienced management and professional advisers.

There is a considerable risk that delays in taking action are affected by share price and reputation consequences. A public company director's reputation should be based on their performance as a steward, not on protections afforded by insolvency legislation or regulation.

Recommendations - Commercial Problems Require Commercial Solutions

Safe Harbour

1. Review the role of major creditors such as the ATO and banks who have access to "inside information" which they use to advance their own interests while allowing directors to continue to trade while possibly insolvent. Their advantage over other creditors should cease from the time that they should have suspected the company to be insolvent.
2. Introduce a time limit on the duration of the safe harbour or establish some form of confidential scrutiny or oversight of its extension. This might enable further flexibility for SME companies, many of whom cannot access it because of the prescriptive protections against abuse e.g. tax payments etc
3. Experts appointed for safe harbour, schemes of arrangement or any other alternative model should be registered liquidators.
4. Access to safe harbour should not be allowed for public company directors, they are adequately protected under the existing law. The confidential and open ended safe harbour arrangements may expose them to other adverse action

Limitations of Consultation

in my submission on the simplified insolvency provisions for small business I identified the urgent need to consult with professionals who had deep experience working with failing businesses and addressing their insolvency. Based on the consultation papers issued in respect of Schemes of Arrangement and Safe Harbour, I conclude that this has not been done.

Professional, business, trade and labour associations are no longer necessarily a sound source of information as they have evolved themselves into large businesses, often administered by professional administrators. For commercial and other reasons membership has often been expanded well beyond the original charter and now comprise wide memberships of significantly diverging

interests which will be engaged in consultation with out necessarily reflecting a predominant view of all members.

Administrators may not have a deep knowledge of the association's industry and the role of the members executive may depend on a wide range of circumstances.

In relation to small business, the Ombudsman's lack of expertise and resources means that they seem to be a megaphone for complaints. I rarely encounter a director who takes responsibility for their own deficiencies, and it is always the bank, tax office, customer or supplier who is the cause of their failure.

In future, and in respect of any review of the current insolvency legislation, it would be more efficient to call for expressions of interest from experienced practitioners and appoint Treasury's own panel of expert practitioners.

Liquidators Review Panel

A major problem that has grown through the life of the VA regime is the increasing involvement of lawyers and consequent case precedent. In addition, given the shrinking pools of assets, sophisticated legal advice is often used to attack the VA or otherwise promote the interests of the creditor or owners above others.

This was probably always unavoidable and will continue to be a problem with any new or revised insolvency framework. Apart from the financial issues significant delays can be caused by the necessity to resolve conflicts in court or even for insolvency practitioners to seek confirmatory advice on a proposed course of action to protect their own interests.

I am suggesting that the feasibility of forming a separate panel of experienced or retired insolvency experts be considered. The panel would report to ASIC, assume some of the load of court approvals, and provide guidance to all parties on the possible outcomes of the proposed actions.

Employee entitlements and the implied government capital guarantee

The liability for leave entitlements unpaid by insolvent companies should only have been borne by the government for an initial transition period.

Any company that commences business should either be profitable and cash positive to cover employee expenses and liabilities or has sufficient capital to cover its losses during the start-up period. Otherwise, the government is effectively guaranteeing the shortfall in company capital that should have been allocated to meeting employee entitlements.

It is preferable that undercapitalised loss-making businesses are immediately wound up rather than years later with many creditors and unfunded employee entitlements.

Regulation to prevent losses

As things stand, just about anyone can open a business with a minimal outlay and proceed to run up liabilities which will never be repaid.

By contrast use of the road is heavily policed with training and licensing requirements dictating the size of vehicle that can be driven. For example, if I am a cyclist and unlikely to cause significant damage to others, then no license and registration is required. If I wish to drive more dangerous vehicles, then I must demonstrate that I have the skills to do so.

There has been endless discussion over director regulation and education to reduce the incidence of business failure and insolvent trading. This is an impossible dream and prescriptive legislation is required to protect profitable well managed businesses from dangerous levels of exposure to failing companies.

While this runs counter to the prevailing view that we need to make requirements less onerous for directors. My view is that we need simple rules on public reporting and oversight of companies depending on factors such as revenue, headcount and liabilities to reduce the incidence of failing companies running up huge liabilities without accountability.