INSTITUTE OF PUBLIC ACCOUNTANTS®

Submission to The Treasury: Review of the insolvent trading safe harbour

October 2021

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The Manager
Market Conduct Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: SafeHarbourReview@treasury.gov.au

Dear Sir/ Madam

Review of the insolvent trading safe harbour

The Institute of Public Accountants (IPA) welcomes the opportunity to comment on the review into the insolvent trading safe harbour. We commend the Government on the ongoing insolvency reforms and reviews.

In preparing this submission, we have undertaken consultation with members who are Registered Liquidators and certified turnaround specialists. In particular, we acknowledge the contribution of Adrian Hunter of Brooke Bird and Ivan Glavas of Worrells.

The IPA is one of the three professional accounting bodies in Australia, representing over 46,000 accountants, business advisers, academics, and students throughout Australia and internationally. Three-quarters of the IPA's members work in or are advisers to small business and small to medium enterprises (SMEs).

Overall, the IPA is supportive of the safe harbour provisions and believes more time and data is needed to make an accurate assessment of their effectiveness. In terms of (interim) changes, we suggest that consideration be given to confidential voluntary disclosure of when the provisions are being utilized. In the interests of minimizing the administrative and regulatory burden for both government and stakeholders, we suggest this could be done through the registers being administered by the ATO (rather than through ASIC).

The other suggestion is to further define or clarify what is meant by 'appropriately qualified entity' which has caused confusion and requires certainty if we are to ensure that businesses, especially small businesses, and SMEs are to receive the advice and assistance they need to ensure their best chance of survival.

These suggestions could be the subject of further consultation with stakeholders.

Our comments follow the questions in the consultation paper and are detailed below.

If you have any queries or require further information, please don't hesitate to contact Vicki Stylianou, Group Executive, Advocacy & Policy, either at vicki.stylianou@publicaccountants.org.au or mob. 0419 942 733.

Yours faithfully

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CONSULTATION QUESTIONS

1. Are the safe harbour provisions working effectively?

It is difficult to make an accurate assessment about the effectiveness of the safe harbour provisions as there is no reporting/ announcement/ disclosure/ lodgment requirement; consequently, most of the work utilizing the safe harbour provisions is carried out 'behind closed doors'.

Further, use of the insolvent trading protections only comes to light if the restructure fails, the company is placed into liquidation, and the liquidator commences an insolvent trading recovery action in the courts against the directors. Then and only then if affidavit material is provided which is disclosed in open court is there any form of public awareness that a safe harbour attempt was undertaken.

Members working in this space have reported that they have not seen a great uptake in inquiries for safe harbour reviews. Rather, there have been more inquiries around conducting a business health check. It may be that some firms which work closely with banks and financial institutions are involved with using the safe harbour provisions.

Member experience in the SME sector is that SMEs often lack the financial capacity to meet the cost of a safe harbour review. The ability to undertake a turnaround contemplated by the provisions is not an inexpensive exercise and there is a convergence of views that SMEs that wish to undertake this process cannot afford it. For instance, undertaking any turnaround is not cheap as it will usually require the business to vacate leased premises, pay redundancy payments to terminated staff and otherwise spend money adapting its business model. This is in addition to the cost of professionals used to assist the directors in this process.

Members specializing in this space advise that where the business has sufficient funds to undertake a successful turnaround and pay for the professional advisors necessary to achieve the desired outcomes, then the safe harbour provisions provide the directors with a degree of comfort in persisting in the process without the fear of losing their personal assets should the turnaround fail.

Reinforcing the above is the view that the safe harbour provisions are working to save large Australian companies, based on the work being carried out by the firms that specialize in turnaround and insolvency for larger firms.

Another factor contributing to the safe harbour provisions not being widely used in the SME market was that these directors are generally already burdened by Personal Guarantees to creditors. Therefore, any insolvent trading protections are largely irrelevant to them because if the business fails, they will already be burdened with guaranteed debt.

In terms of assessing the effectiveness, one measure would be to consider what is being charged for a safe harbour review and the outcome, that is, have the safe harbour advisors 'successfully assisted the directors to achieve a better outcome'; and compare this to say a voluntary administration (which may eventually become a liquidation) or a straight liquidation.

2. What impact has the availability of the safe harbour had on the conduct of directors?

Again, there is no reporting of safe harbour utilization making it difficult to make this assessment. However, given that the number of large insolvency administrations has decreased compared to pre-covid numbers, it may be fair to assume that safe harbour reviews could be occurring. At least this may be one factor for the decrease in insolvencies.

Anecdotally, the safe harbour provisions provide a 'talking point' for professional advisors to have educational discussions with directors regarding the ability to turnaround their business. Directors are generally alert to insolvent trading and these provisions provide a level of comfort to directors as part of the wider 'turnaround' offering able to be put to the directors when contemplating this process.

It was a widely held view that the provisions alone do not guarantee success but rather help to allay the fears of directors in the event of a turnaround failure.

3. What impact has the availability of the safe harbour had on the interests of creditors and employees?

It is difficult to assess the impact of the availability of the safe harbour provisions on the interests of creditors and employees, given the lack of data and an economy with extended periods of lockdown and excessive government assistance.

We have received comments to the effect that the omnibus legislation which permitted directors to trade whilst insolvent from March 2020 to the end of December 2020 essentially made the safe harbour process redundant. From January 2021 onwards, it may be different, however, there has been insufficient data (and experience) to form a reasonable view, other than anecdotally.

Arguably, any business that turns itself around so that liquidation is avoided will preserve value for creditors and employees. Employees have ongoing job security together with the payment of their entitlements (including superannuation) while creditors are likely to be unaware that their payments were ever in jeopardy.

4. How has the safe harbour impacted on, or interacted with, the underlying prohibition on insolvent trading?

In addition to the comments made above, we have also received the following views.

Upon liquidation, insolvent trading investigations will be undertaken by the appointed liquidator. As part of these investigations, consideration will be given as to the defences available to the company's directors before any prosecution of a claim is commenced. In the event that the directors had been undertaking a turnaround prior to collapse then the tests for whether the directors are able to avail themselves of the safe harbour protections will be considered.

Where a turnaround has been undertaken which has then failed, these provisions provide a further layer of defence to those already available under Section 588H of the *Corporations Act* 2001. Accordingly, there is a clear interaction between safe harbour provisions and the prohibition on insolvent trading.

Importantly, prior to undertaking a turnaround, a director will need to familiarise themselves with the pre-conditions to obtaining safe harbour protections which can, of itself, be a valuable exercise for the directors to undertake in assessing whether their contemplated turnaround is worthwhile and achievable. Many directors want to do a turnaround despite the untenable position the company finds itself in. Therefore, this 'reality check' provides a worthwhile pause before rushing into any ill-conceived turnaround plan.

5. What was your experience with the COVID-19 insolvent trading moratorium, and has that impacted your view or experience of the safe harbour provisions?

There has been a convergence of member views to this question, which are summarized below.

The covid-19 insolvent trading moratorium created the perfect environment for pre-insolvency advisors to flourish which may lead to a substantial number of 'no-asset' or 'stripped-asset' zombie company liquidations once the ATO start dealing with the non-payers. Combine this with a very generous Federal government support program (including JobKeeper, JobSaver, JobSeeker) and continuous uncertainty in the economy due to the ever-present fear of another lockdown (particularly in Victoria and NSW) and the result is reduced business confidence.

Logically, this is likely to result in an increased use of the safe harbour provisions, however, this doesn't appear to be the case. Two possible reasons could be firstly, the cost of the safe harbour review which is potentially cost prohibitive to a financially distressed organisation or

smaller organisations such as SMEs; and secondly, phoenixing, which may be far more attractive in terms of cost, expediency, and scrutiny.

The COVID-19 protections, rather than providing for director protections to enable a turnaround to proceed, have acted as an excuse for some to avoid the reality that their business is insolvent and should be liquidated. Its blanket application has resulted in many insolvent businesses continuing to trade and incur larger debts, at the cost of creditors (including landlords), without any remedial action being taken by the directors.

It is these protections, combined with the continued flow of Government funds into businesses, that has arguably seen insolvency rates drop below 60% of their pre-covid levels. Despite the utopian view that no business should fail, the reality is that a healthy economy will have a business lifecycle involving both start-ups and failures to redistribute capital and resources (including employees) from failed businesses into those which are profitable and well run. The COVID-19 moratorium has upset this natural balance and masks the underlying issues for some businesses.

It would be useful to have accurate and timely data on the presence of zombie companies, defined for current purposes as those which are continuing to trade, incurring trade debt, receiving Government support, and not paying tax (we acknowledge there are various definitions). Further, it would be useful to have research data on the impact of these zombie companies on the operation and profitability of businesses which are operating without government support, paying taxes, and employing staff. We are aware that some research and analysis has been done by the Reserve Bank and others, including an assessment on productivity growth. The IPA Deakin SME Research Centre has considered aspects based on access to BLADE and would be able to undertake further research and analysis for the benefit of the IPA's policy development in this area.

6. Are you aware of any instances where safe harbour has been misused?

All the feedback has been in the negative, that is, no awareness of any misuse of the provisions.

7. Are the pre-conditions to accessing safe harbour appropriate?

The pre-conditions are as follows:
"…the person:

a) is properly informing himself or herself of the company's financial position; or
b) is taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all its debts; or

c) is taking appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company; or
d) is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; or
e) is developing or implementing a plan for restructuring the company to improve its financial position.

One of the main issues has been around the definition of 'appropriately qualified entity' and the need for more clarity as to what constitutes 'appropriately qualified'. It is noted that while most of the pre-conditions represent benchmarks for good governance, there is no stipulation within the legislation under pre-condition d) as to who is an appropriately qualified entity. In this regard, it is open to potential abuse by those who are not suitably qualified and not acting ethically, to the detriment of trusting directors.

To avoid this situation we recommend that the legislation be amended to provide certainty around what is meant by 'appropriately qualified entity'. This could be defined as a registered liquidator or at the very least someone who is a qualified accountant under the Corporations Act and has undertaken further relevant studies which can be subject to consultation and prescribed in regulations. In this way, there will be certainty that the entity is subject to a Code of Ethics, disciplinary processes, mandatory Continuing Professional Development (CPD) and minimum qualifications.

A company taking advantage of the safe harbour provisions could be or is likely to be insolvent, and it could be a precursor to an external administration. For this reason, it may offer greater protection for creditors if a registered liquidator was supervising the process. Further, the role of monitor (during the turnaround process) should be filled by someone who is subject to regulation by ASIC, preferably has relevant experience in dealing with financially distressed companies (or is under the supervision of such a person) and importantly, has appropriate professional indemnity (PI) insurance. Even with liability waivers in place, PI insurance can still be difficult to obtain for work in this sector and we are advised by IPA's in-house broker, that the PI insurance market has been contracting. The Restructuring Practitioners requirements can be leveraged in this context.

Other comments received were that the pre-conditions are not appropriate in that it is unreasonable to expect a financially distressed company to pay all its employee entitlements and lodge all its returns, and this will severely limit the number of contenders to use the safe harbour process. This is more likely to apply to SMEs and small businesses. We expect that data will be available from the ATO, ASIC and FEG on this point. We offer an option below on dealing with this situation.

Furthermore, the concept of achieving a 'better outcome' versus that of a voluntary administration or liquidation would be properly considered for the benefit of creditors and balanced with other stakeholders.

With the commencement of the *Insolvency Law Reform Act* 2016 (Cth) (ILRA) in March 2017, the process for obtaining registration as a liquidator was changed to allow more scope for

who could obtain registration while maintaining the standards required of such a role. As such, there is capacity for appropriately qualified people to obtain their registration. Importantly, the ILRA also specified a range of minimum educational and experience requirements to ensure the competency of a person fulfilling these roles.

A registered liquidator acting in these roles is not an 'island' or 'silo' and will be supported by the necessary lawyers and other advisors appropriate for the company or corporate group involved – similar to the multi-faceted professional service currently offered for entities during a period of external administration.

8. Does the law provide sufficient certainty to enable its effective use?

Overall, the responses we received were in the negative, that is, the legislation is broadly drafted and may require judicial interpretation to clarify some of the main purposes of using the regime, such as what is deemed to be 'reasonable' and 'provides for a better outcome'. Clarity is also needed around the provision that the director 'is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice'.

The above concepts or terms are ambiguous and open to interpretation and potential abuse and should be clarified. (Refer to comments above.)

9. Is clarification required around the role of advisers, including who qualifies as advisers, and what is required of them?

Yes. Currently, the legislation would not preclude unqualified, unregulated, and inexperienced pre-insolvency advisers or individuals from dealing with distressed businesses, and to the detriment of directors, creditors and employees.

Refer to comments above relating to the need to provide further clarity and certainty around 'appropriately qualified entity'.

10. Is there sufficient awareness of the safe harbour, including among small and medium enterprises?

We believe there is definitely sufficient awareness among accountants and consequently their clients including SMEs. Most accountants would refer to specialists in insolvency and turnaround; and would not have the required PI insurance to undertake the work themselves.

The IPA has undertaken extensive member communications and CPD on the insolvency reforms to raise awareness; and promotes the referral to suitably qualified specialists.

11. In relation to potential qualified advisors, what barriers or conflicts (if any) limit your engagement with companies seeking safe harbour advice?

The response received from all members was there are no barriers or conflicts in this context.

There may be barriers or conflicts which limit engagement for those who are not suitably qualified and seeking to take advantage of vulnerable directors.

12. Are there any other accessibility issues impacting its use?

The overall view is that the legislation is accessible. While the process of undertaking a turnaround is in itself prohibitive to many SMEs, this is not as a result of the legislation. As discussed above, undertaking a turnaround is not an inexpensive exercise nor can it usually be achieved quickly given the processes and competing interests that must be considered.

For larger businesses and those with more resources which can afford the necessary professionals to provide them with appropriate and competent advice, they can access the safe harbour protections as necessary.

13. Are there any improvements or qualifications you would like to see made to the safe harbour provisions and/or the underlying prohibition on insolvent trading?

Whilst we appreciate the policy objectives of ensuring that employees are paid all of their entitlements and we entirely agree with this obligation, there is also the view that a balance should or could be struck between this obligation and the need to ensure that financially distressed companies are offered every chance of survival. This preserves employment and economic activity with flow on benefits. One option for striking this balance could be:

- limit the requirement to pay all employee entitlements to allowing for a certain range of liabilities; for example, outstanding employee superannuation must not be more than 12 months, no unpaid wages, unpaid leave limited to 12 months;
- outstanding ATO lodgments to be completed within 3 months of the safe harbour regime being adopted;
- a registered practitioner or appropriately qualified entity be required to conduct the safe harbour;
- removing any minimum or maximum creditor limit for accessing the safe harbour protections (akin to what exists in the Small Business Restructure process);
- these provisions should be and be seen to be available to those businesses of sufficient size worth saving in the wider context of the Australian economy.

Other member feedback:

In essence, the insolvent trading laws are there to prevent directors/ business owners from not dealing with their responsibility to, for example, pay wages, taxes, their creditors, stop underquoting just to win the work and taking on work which may not pay. A good example of this can be seen in the construction industry and more recently the labour hire services industry where phoenixing appears not uncommon and underquoting is progressively creating serious issues for the sector.

For liquidators the cost of doing business would increase substantially if there was no certainty of being paid for their services. Inevitably, this would lead to passing on costs for those who may not be able to pay, which would not be viable as a business model.

One suggestion to improve the insolvent trading regime is more effective regulatory intervention from ASIC and ATO. [However, IPA would not support increases in the ASIC industry funding levy and believes that more effective regulation can be undertaken within the current funding model.] There is the opportunity for innovation and entrepreneurialism across the sector. Further consultation would be beneficial.

The law is there to protect people's right to be paid for the goods and services they provide. The interests of all stakeholders should be balanced, including those of creditors who are often at the end of the chain of an insolvency event, and are often left unpaid which puts their own livelihood at risk.