Submission to the Parliamentary Joint Committee on Corporations and Financial Services: corporate insolvency in Australia

December 2022

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Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

By email: corporations.joint@aph.gov.au

Dear Sir/Madam

Corporate insolvency in Australia

The Institute of Public Accountants (IPA) welcomes the opportunity to comment on the inquiry into corporate insolvency in Australia.

The IPA is one of the three professional accounting bodies in Australia, representing over 50,000 members and students. Three-quarters of the IPA's members work in or are advisers to small business and small to medium enterprises (SMEs).

The IPA has had the benefit of reading the submissions made to this Inquiry by the Association of Independent Insolvency Practitioners (AIIP). The AIIP and IPA have joint members who are Registered Liquidators and insolvency practitioners and specialists. The IPA has also had the benefit of reading the submission to this Inquiry of the Condon Advisory Group.

Overall, the IPA supports the views and recommendations contained in the submissions of both the AIIP and the Condon Advisory Group. We acknowledge their extensive experience and expertise in the insolvency sector and of the broader business and SME environment.

We also acknowledge the contribution of other IPA members who are Registered Liquidators and insolvency specialists, who have generously provided their contribution to forming the IPA's views and recommendations to this Inquiry and to the various other insolvency reforms and consultation which has been undertaken since 2019.

In previous submissions the IPA advocated for a review of the insolvency reforms within 12 months from commencement, given the piecemeal nature of the series of reforms and changes. For instance, IPA has lodged 11 submissions of direct and indirect relevance to this Inquiry since 2020. Unsurprisingly, it was almost inevitable that unintended consequences would emerge, which they have.

Therefore, we strongly welcome this Inquiry as there is still a need to reform the insolvency framework in a holistic manner for the benefit of small businesses, shareholders, creditors, consumers, and insolvency practitioners.

The IPA has made comments below in response to some of the Terms of Reference. Specifically, we refer to Small Business Restructuring (SBR) and SBR practitioners, trusts with corporate trustees and the insolvent trading safe harbour. Essentially, there is a need to:

- simplify the SBR framework to make it more accessible;
- reform the use of trusts;
- retain the safe harbour provisions (at least for now); and
- replace ASIC with a specialist insolvency regulator which can also make determinations.

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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COMMENTS IN RESPONSE TO THE TERMS OF REFERENCE ON THE INQUIRY INTO CORPORATE INSOLVENCY IN AUSTRALIA

1. Recent and emerging trends in the use of corporate insolvency and related practices in Australia.

We are now seeing more businesses take advantage of the small business restructuring provisions as a response to the ATO collecting small business tax debt. We note that half of the $12 billion tax debt is owed by small businesses, who were shielded during the pandemic due to the generous economic stimulus payments. However, our members who are Registered Tax Agents, are now reporting that these small businesses that were artificially kept in business are struggling to meet their financial obligations, for a variety of reasons, and are seeking payment programs or insolvency relief. It is opportune, therefore, that the simplified liquidation reforms, including SBR, have been introduced. On the other hand, if it does not operate as efficiently and effectively as intended, then some of these businesses may not receive the benefit and go into liquidation.

2. The operation of the existing legislation, common law, and regulatory arrangements, including:

- **the small business restructuring reforms (2021); and**
- **the simplified liquidation reforms (2021).**

There was a lot of anticipation among IPA members that the SBR reforms would alleviate some of the challenges faced by small businesses which were in financial distress but still salvageable. However, this early promise that the reforms would solve some of the issues was not realized and many IPA members did not take up the SBR practitioner pathway.

The SBR practitioner pathway was complex and onerous in its design and requirements, and it seemed ASIC was ill-equipped to make the necessary assessments of qualifications in a reasonable time period. Consequently, only a small number of IPA members took up the new SBR registration. In addition, we were advised by members who are qualified insolvency practitioners that they had capacity to deal with the liquidations which were occurring during the height of the pandemic. The wave of liquidations which was initially anticipated did not occur, presumably due to the COVID stimulus payments. Given the lack of client demand, there was even less reason for our members to qualify under the new SBR pathway.

The IPA believes there is still a role for the SBR practitioner, however, it should be as an early stage adviser and mostly relating to assessing the financial viability of the business, and prior to the preparation of a reconstruction plan. Otherwise, relevant insolvency related qualifications should be required beyond this early stage. It might be that a restructure and renaming of this pathway is needed. In a previous submission, the IPA outlined a suitable training course which was specifically developed by Deakin University to suit this early stage SBR practitioner. After a certain point, it becomes evident that specialized training, skills,

and experience are needed, which means referral to a Registered Liquidator or turnaround specialist is recommended and in fact essential.

For instance, the turnaround process is more than debt restructuring and cashflow reports, which was the focus in the exposure draft to the reforms. The reforms lent on the Voluntary Administration process and Part X Debt Agreements, which it may be fair to say only Registered Liquidators and/or Registered Trustees have the necessary familiarisation and working knowledge of these to ensure the correct administration of the new simplified process. Further, the interactions of these new insolvency regimes with the existing laws concerning the *Personal Property Securities Act* 2009 (PPSA) and Secured Creditor appointments (via a Receivership) also need to be considered.

If the optimal balance between a suitably qualified SBR practitioner and having an effective and efficient process is not reached, then the reforms may be undermined.

3. Other potential areas for reform, such as:
   - **a. trusts with corporate trustees; and**
   - **b. insolvent trading safe harbours.**

Trusts with corporate trustees

In principle, IPA supports the recommendations relating to trusts made in the Harmer Report in 1988. Obviously, some adaptation will need to be made given that over 30 years have passed since the report was delivered.

We are advised by members that the involvement of trading trusts (and other types of trusts) create undue complexity and cost, which can make it difficult to realise and distribute funds to unsecured creditors. The common solution is a Court application for orders which is costly given so many SMEs use this structure for day-to-day trading.

As to whether the corporate insolvency framework should be amended so that it expressly provides for the external administration of insolvent trusts with a corporate trustee, we believe that amendments are needed to all external administration processes.

The legislative framework needs to deliver certainty and reduce the cost of requiring Court proceedings, as well as reducing the overall compliance and administrative burden currently experienced by many practitioners and their clients. Many of these complexities are specific to the existence of a trust and are not encountered with other insolvencies. Clarifying definitions is fundamental to this process, including when a trust is considered to be insolvent. This would generally support the Harmer recommendations.

It will also be necessary to consider the impact of and interaction with the insolvency reforms including SBR and simplified insolvencies which would also apply to businesses that utilize corporate trusts. It is conceivable that these reforms have introduced another level of complexity which needs to be clarified; and to ensure that the intended policy objectives to simplify the process and reduce the cost of small business insolvencies are not undermined.

Insolvent trading safe harbours

Overall, the IPA is supportive of the safe harbour provisions and believes more time and data are needed to make an accurate assessment of their effectiveness. 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.

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, and that larger businesses are able to take advantage of the 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 an expensive exercise and there is a consensus of member 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 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.

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 them as part of the wider 'turnaround' offering able to be put to the directors when contemplating this process.

It was a widely held member 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.

Upon liquidation, the appointed liquidator will undertake insolvent trading investigations. 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. Some 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.

The COVID 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 starts dealing with the non-payers. Combine this with the generous stimulus payments and continuous uncertainty in the domestic and international landscape and the result is reduced business confidence.

Members advise that the cost of the safe harbour review which is potentially cost prohibitive to a financially distressed organisation or smaller organisations, makes it less attractive than phoenixing, which is less expensive, expedient, and often, escapes the same level of scrutiny as utilizing the safe harbour provisions. Members have reported anecdotally that phoenixing still seems to be occurring, especially in the construction sector. The introduction of director IDs will hopefully assist in alleviating this situation.

In terms of whether the pre-conditions to accessing the safe harbour provisions are appropriate we make the following comments.

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 as to who or what 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. In this way, there will be certainty that the entity is subject to a Code of Ethics, disciplinary processes, mandatory Continuing Professional Development (CPD), minimum qualifications and has professional indemnity insurance.

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.

There was consensus among IPA members that the legislation does not provide sufficient certainty to be effective. It 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'.

If the legislation provided more certainty, then it may go some way to dealing with unregulated pre-insolvency advisers. Currently, the legislation would not preclude unqualified, unregulated, and inexperienced pre-insolvency advisers or individuals from dealing with distressed businesses, to the detriment of directors, creditors, and employees.

Improvements and qualifications to the safe harbour provisions include the following:

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; and

- removing any minimum or maximum creditor limit for accessing the safe harbour protections (akin to what exists in the SBR process).

One suggestion to improve the insolvent trading regime is more effective regulatory intervention from ASIC and ATO. However, IPA does 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.

4. Supporting business access to corporate turnaround capabilities to manage financial distress.

The IPA has previously advocated for a small business viability initiative, which would enable small businesses to access professional advice at an early enough stage to afford every chance of financial survival. We have found widespread member support for a small business viability review assessment measure. This would be as a first stage in the process, prior to the commencement of any formal restructuring process. To assist financially stressed small businesses, the Government could consider a grant to pay for the advice, which could be returned through the tax system if the business survives. It has been widely documented that all too often, small business owners will not seek help until it is too late or almost too late. In order to prevent small business insolvency we believe that it is critical to address some of the underlying issues. If small business owners can be encouraged to seek assistance before it becomes too late, then the policy objective of preventing small business insolvencies (or saving small businesses to grow into the future) can be further supported and in fact, strengthened.

We have also been advised that many small businesses will not want to be associated with the stigma of insolvency and may stay away from a formal pre-insolvency process. This is another reason to support a business viability review which takes a different, non-threatening and supportive perspective and may be more appealing to small business owners. Likewise, putting a restructuring plan to creditors may be off-putting for small business owners. On the other hand, a business viability review by a qualified professional adviser may have a higher probability of achieving the desired policy outcome of preventing small business insolvency.

5. Role, remuneration, financial viability, and conduct of corporate insolvency practitioners (including receivers, liquidators, administrators, and small business restructuring practitioners).

For liquidators, the cost of doing business can be extremely onerous and members have advised that up to 70 per cent of their fees may be written off. More needs to be done to support the practice of insolvency and in this regard we support the comments by the AIIP and the Condon Advisory Group and urge the Inquiry to address this issue.

6. **The role of government agencies in the corporate insolvency system, including:**
    a. **the role and effectiveness of ASIC as the corporate insolvency regulator.**

The IPA has been critical of ASIC for a considerable period of time. We have made numerous submissions to government, including to ASIC, on its performance across a number of areas. This has included the recent review of the Industry Funding Model, regulator performance review by the Dept of Prime Minister & Cabinet, the ongoing review by the Financial Regulator Assessment Authority, reviews of ASIC's KPIs and metrics for its KPIs, as well as past inquiries into ASIC's capabilities and the comments from the Hayne Royal Commission. However, nothing seems to have improved in terms of ASIC's performance.

We note that recently two Parliamentary inquiries, including by this Committee, have been announced into ASIC's capacity and capability to respond to reports of alleged misconduct, and by the Senate Economics References Committee into ASIC's investigation and enforcement. The need for these inquiries, which the IPA strongly welcomes, speak for themselves in terms of the capability of ASIC.

The IPA holds the view that ASIC's remit is too broad, and ASIC simply does not have the resources or the inhouse expertise to adequately regulate the corporate insolvency sector. Also, there is no compelling reason why corporate insolvency and personal bankruptcy should not be jointly dealt with. Instead we have corporate insolvency under ASIC and personal insolvency under AFSA.

Our recommendation is that the insolvency function (both corporate and personal bankruptcy) should be moved to a specialist regulator which has the powers, resources, and expertise to regulate the entire sector. This should include the power to arbitrate between parties and to make determinations on the day to day actions currently carried out by the Courts. In this way it could vastly reduce legal costs and be more timely in its processes. This would present a significant benefit for many small businesses and make the practice of insolvency more attractive for professionals.