
Corporate insolvency

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THE PRODUCTIVITY COMMISSION, CORPORATE INSOLVENCY AND PHOENIX COMPANIES

OVERVIEW

In May 2015 the Productivity Commission released its Draft Report entitled “Business Set-up, Transfer and Closure”.¹ Further submissions were sought by 3 July 2015. In simple terms, the Productivity Commission was asked to “conduct a broad ranging investigation into barriers to business entries and exits and how or where it might be efficiency-enhancing to reduce such barriers.”² Business entries and exits are said to be part of the market forces that lead to innovation, competition, firm efficiency and economic growth.³ The Draft Report found that the vast majority of new businesses were micro-businesses with few (less than four) or no employees, and that only one to two per cent were innovative in some way.⁴ This note does not deal with the broad range of issues touched on by the Productivity Commission. Instead, it concentrates on those matters relating to corporate insolvency and in particular, the recommendations that are relevant to dealing with phoenix companies.

The Productivity Commission concluded that “overall, the insolvency regime is operating well”.⁵ It did not endorse the adoption of a United States (US)-style Ch 11 approach,⁶ nor did it recommend the merging of the personal and corporate insolvency regimes or regulators.⁷ Rather it suggested some other systemic changes that could improve the restructuring process in Australia while avoiding pitfalls with the US approach.⁸

The first of these is an encouragement to earlier entry into voluntary administration (VA). This would allow a genuine opportunity to save the company or facilitate restructure prior to insolvency while the business retained some assets.⁹ In this context, the Productivity Commission recommended both a “safe harbour” against insolvent trading for directors,¹⁰ as well as “pre-positioned” sales (the Australian Restructuring Insolvency and Turnaround Association’s (ARITA) preferred term for

¹ Australian Government Productivity Commission, *Business Set-up, Transfer and Closure*, May 2015 (Draft Report), <http://www.pc.gov.au/inquiries/current/business/draft>.

² Australian Government Productivity Commission, n 1, p iv.

³ Australian Government Productivity Commission, n 1, p iv.

⁴ Australian Government Productivity Commission, n 1, pp 4, 347.

⁵ Australian Government Productivity Commission, n 1, p 18.

⁶ Australian Government Productivity Commission, n 1, pp 344-345.

⁷ Australian Government Productivity Commission, n 1, p 318. The Productivity Commission considered likely benefits to be “marginal” although it did suggest that the government “should aim to align the requirements under personal and corporate insolvency laws where possible and practicable”.

⁸ Australian Government Productivity Commission, n 1, pp 20, 347, Ch 15.

⁹ Australian Government Productivity Commission, n 1, pp 350-351. “Pre-positioned” sales are “non-distressed sale[s] ... organised in the period immediately prior to a formal insolvency appointment”: p 21.

¹⁰ Australian Government Productivity Commission, n 1, pp 352-365.

“pre-packs”) during safe harbour periods.¹¹ To safeguard against impropriety during these periods, “pre-pack” sales would be reviewed in the event that the company subsequently entered external administration, particularly where related parties were involved in the purchase. This is important in the context of ensuring that “pre-packs” do not become a screen for illegal phoenix activity. The Productivity Commission considered that VA and the associated recommendations should not be available where the company was already insolvent or close to insolvency. This is a sensible suggestion. It avoids VA becoming “the scenic route to liquidation”¹² and a temporary means of staving off insolvent trading liability.¹³ It should be noted that the use of VA has declined in recent years,¹⁴ arguably because creditors are reluctant to see company assets wasted exploring pointless attempts at restructuring and so may not be of much practical use.

The second recommendation is the voiding of ipso facto clauses.¹⁵ These clauses provide for a contract to be terminated despite continued performance such as payment where, for example, an administrator is appointed. This prevents companies being sold as “going concerns” and discourages company controllers from seeking the administrator’s appointment. This change has long been supported by members of the insolvency profession.¹⁶ The Productivity Commission’s recommendation limits the moratorium on ipso facto clauses to situations where there is some prospect of the company being able to continue.¹⁷ Where the company is to be liquidated, the reasoning behind the moratorium does not apply.¹⁸

The third recommendation is designed to reduce the time and expense involved in liquidations with few or no assets. The Productivity Commission felt that this could be achieved through a simplified “streamlined” approach for micro and small liquidations involving less than \$250,000 in liabilities.¹⁹ The liquidator’s main task would be locating assets and verifying that there had been no illegality. Other liquidation procedures would be reduced. Liquidator fees would be determined through tender.

We believe that the Productivity Commission should proceed carefully on this proposal. The Draft Report speaks of liquidations where “very little is at stake and there is no suggestion of criminal activity”.²⁰ With respect, this approach is circular. Until there is an investigation by a liquidator, criminal activity might remain “unsuggested”. There is a real risk that small companies will load themselves with tax and employee entitlement debts just short of the prescribed amount, liquidate the company and start the business again through a new entity. The liquidator, whose fees are driven down through competition, has little incentive or means to investigate whether the official story presented by the company’s controllers is true or in fact masks illegal phoenix activity through breaches of directors’ duties. There is an unresolved tension between the liquidator’s duty to investigate and report to the Australian Securities and Investments Commission (ASIC),²¹ and the acknowledgment that

¹¹ Australian Government Productivity Commission, n 1, pp 357-360.

¹² Schaffer R, “The Rise and Fall of Voluntary Administration” (2010) 10(10) *Insolvency Law Bulletin* 160.

¹³ The eventual liquidator is not prevented by an earlier VA from seeking recovery from directors for insolvent trading. ASIC can still seek a civil penalty against a director for insolvent trading during VA: *Elliott v Australian Securities and Investments Commission* (2004) 10 VR 369; 185 FLR 245 at [184]-[185].

¹⁴ See Anderson H, “Voluntary Administration and the Protection of Employee Entitlements” (2012) 30 *Company and Securities Law Journal* 170 at 175. The trend of these statistics has continued. By 2013-2014, VAs accounted for only 12.3% of external administrations, compared to 45% for creditor-initiated liquidations.

¹⁵ Australian Government Productivity Commission, n 1, p 360.

¹⁶ See, eg, the submissions to the Australian Government Productivity Commission, n 1, p 361.

¹⁷ Australian Government Productivity Commission, n 1, Draft Recommendation 15.4, p 363.

¹⁸ Australian Government Productivity Commission, n 1, p 362.

¹⁹ Australian Government Productivity Commission, n 1, Draft Recommendation 15.5, p 368. The recommendation refers to this as a simplified “small liquidation” process.

²⁰ Australian Government Productivity Commission, n 1, p 388.

²¹ *Corporations Act 2001* (Cth), s 533.

liquidators are not obliged to do more than report where there are insufficient funds in the company.²² In these circumstances, the Australian Tax Office (ATO) may simply write off the amounts owing to it and the employees will seek advances from the Fair Entitlements Guarantee. Creditors close to the company who might otherwise be suggesting criminal activity could be quietly paid in full and continue to supply the business in its new corporate guise.

In addition, we understand that some pre-insolvency advisors are stripping businesses of assets to make them unattractive to liquidators at any price. In these circumstances, in the absence of a creditor willing to fund a liquidator to investigate, the company is likely to remain dormant and eventually be deregistered by ASIC. We also caution against the use of the terminology “criminal activity”. Few directors’ duty breaches are sufficiently dishonest to warrant that expression. Most improper behaviour involving breaches of directors’ duties would amount to breaches of the civil penalty provisions of the *Corporations Act 2001* (Cth).²³ A better term would be illegal activity.

The Draft Report also raises the issue of the role and funding of the corporate regulator, ASIC.²⁴ After commenting that “changes in the law can have little impact if they are not implemented, enforced and monitored properly”, the Productivity Commission tactfully notes that it “is mindful that regulators in this area, particularly ASIC, [may not] have the appropriate resources and approaches required to give effect to the necessary reforms.”²⁵ We echo this call. It is a “penny-wise, pound foolish” approach to skimp on the enforcement funds made available to ASIC, while at the same time bemoaning the loss of tax revenue and the cost of the Fair Entitlements Guarantee.

Nonetheless, it has long been recognised that ASIC cannot undertake all detection and all enforcement itself.²⁶ Liquidators play a vital role as ASIC’s “gatekeepers” and must be paid appropriately for their work. The aim of the Assetless Administration Fund (AAF) is to overcome the inability of liquidators to make proper investigations due to financial constraints.²⁷ There is a cap, currently \$7,500, or \$8,250 once the goods and services tax is included, on the amount of funding provided which is unlikely to permit extensive investigations. The Draft Report notes that streamlined small liquidations, discussed above, might involve a greater call on the AAF where the liquidator needs to convert the process into a full liquidation having discovered suspected illegal activity.²⁸ It is to be hoped that the AAF also funds the streamlined small liquidations themselves, to ensure that the initial detection of illegal activity takes place.

The Productivity Commission asks²⁹ whether the additional funding required by the AAF might be raised through a small levy on the annual review fee for Australian Company Numbers. This is an excellent suggestion that goes some way to properly pricing the privilege of incorporation. It is possible that this additional charge may be characterised by some as an impost on business that damages the economy. On the contrary, by providing liquidator funding to identify and report illegal behaviour, this has the potential to be money well spent by the business community in reducing the

²² *Corporations Act 2001* (Cth), s 545(1): “[A] liquidator is not liable to incur any expense in relation to the winding up of a company unless there is sufficient available property.” Section 545(3) says: “Nothing in this section is taken to relieve a liquidator of any obligation to lodge a document (including a report) with ASIC under any provision of this Act by reason only that he or she would be required to incur expense in order to perform that obligation.” Liquidator funding is taken up further below.

²³ *Corporations Act 2001* (Cth), ss 180–183.

²⁴ Australian Government Productivity Commission, n 1, p 384.

²⁵ Australian Government Productivity Commission, n 1, p 384.

²⁶ Regulatory scholars recognise that usually most public regulators will have insufficient resources to detect, investigate and initiate enforcement action in response to every contravention that occurs: see Ayres I and Braithwaite J, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, 1992); Braithwaite J, *Regulatory Capitalism: How it Works and Ideas for Making It Work Better* (Edward Elgar, 2009).

²⁷ ASIC, *Assetless Administration Fund: Funding Criteria and Guidelines, Regulatory Guide 109* (November 2012) RG 109.1.

²⁸ Australian Government Productivity Commission, n 1, p 366.

²⁹ Australian Government Productivity Commission, n 1, p 386.

incidence of fraudsters abusing the corporate form. The more prevalent illegal debt-avoiding behaviour becomes, the more difficult it is for legitimate operators to compete.

The Productivity Commission also asks whether the AAF criteria should be changed, possibly removing the requirement for the liquidator, at their own expense, to conduct an initial investigation to see whether a further investigation was required.³⁰ The logic of this seems self-evident. If the objective of the AAF is to empower liquidators to be effective gatekeepers and investigators, it is important that they are appropriately funded to do so. It must be remembered that liquidators are private sector professionals with their own expenses to pay.

CORPORATE INSOLVENCY AND PHOENIX COMPANIES

It is pleasing to see that the Productivity Commission has adopted³¹ our recommendation relating to director identification numbers (DIN). The DIN was also supported by ARITA. The DIN would be established through a 100 point identity check similar to that required when opening a bank account. We submitted that the DIN should eliminate the problem of fictitious identities being used for company directorships when new companies are registered and assist ASIC in detection of other wrongdoing. It would also assist agencies such as the ATO, the Australian Crime Commission and the Australian Federal Police. Our research suggests that tackling illegal phoenix activity will involve multiple measures spanning enforcement, deterrence and prevention. A DIN would be one such measure, rather than a solution on its own.

Our submission to the Productivity Commission commented on the limited data obtained by ASIC through external administrators' statutory reports, and recommended further scope for qualitative comments to be made. In response the Productivity Commission noted the improvements to ASIC's practices and powers which would come through the enactment of the *Insolvency Law Reform Bill 2014* (Cth), and it considered that these changes should be allowed to operate before further improvements were suggested.³² For this reason among others, it would be useful for the present federal government to make its position clear on the future of the Bill.

Another legislative change that remains pending relates to the redundancy entitlement available under the Fair Entitlements Guarantee (FEG). On 1 January 2011, the federal government removed the cap that limited entitlements to a maximum of four weeks per year of service to a maximum of four years – in effect a 16 weeks cap. After that date entitlement became four weeks per year of service. When the measure was announced prior to the 2010 election, the government estimated the cost of this change at \$11.6 million in 2010-2011, \$15.1 million in 2011-2012, \$16.9 million in 2012-2013 and \$17.2 million in 2013-2014.³³ This gives a sense of the extent to which employees had previously been underpaid in redundancy advances due to corporate insolvency. Prior to its election in 2013, the Coalition government promised to reinstate the 16 week cap. However, the legislation proposed to do this has not yet passed the Parliament.³⁴

The Productivity Commission examined the changes to the redundancy cap. It recommended³⁵ that the proposed reduction go ahead to address moral hazard issues, subject to a review in 2021. The term “moral hazard” refers to the willingness of company controllers to place their insolvent companies into liquidation without making adequate provision for employee entitlements, safe in the knowledge that their workers would be looked after by the government scheme. The Department of Employment had submitted to the Productivity Commission that there had been an increase in

³⁰ Australian Government Productivity Commission, n 1, p 385.

³¹ Australian Government Productivity Commission, n 1, Draft Recommendation 15.8, p 384.

³² Australian Government Productivity Commission, n 1, p 385.

³³ Department of Finance and Deregulation, “Release of Costing of Election Commitment”, Media Release GOV05 (3 August 2010), http://electioncostings.gov.au/files/2010/07/GOV05-Fair_Entitlements_Guarantee-Completed.pdf.

³⁴ *Fair Entitlements Guarantee Amendment Bill 2014* (Cth).

³⁵ Australian Government Productivity Commission, n 1, Draft Recommendation 15.7, p 379.

workplace agreements allowing for the greater redundancy amount, in the apparent belief that the government would cover these costs in the event of insolvency.³⁶

However, it is not clear that the reduction in the cap will affect the willingness of company controllers to liquidate companies and rely on the government to fund unpaid employee entitlements. The more generous allowance was only introduced in 2011 and the number of businesses whose employees sought advances from the government scheme did not rise as a result. The Department of Employment's submission showed that the proportion of insolvent entities whose employees had sought government assistance had risen from 17% in 2006-2007 to 21% in 2013-2014, after peaking at 23% in 2009-2010.³⁷ Given the apparent drop after the 2011 introduction, it is difficult to argue that the more generous cap adds to moral hazard. A more likely explanation for the figures exceeding the 2006-2007 amounts is the global financial crisis and its aftermath, including the well-publicised closures of manufacturing businesses in Australia.

The main argument that could be made for the 16 week cap is to rein in costs to ensure the scheme remains financially viable. This is a legitimate aim but it must be recognised that it comes at a cost to those employees who have been with their insolvent employer for more than four years. For example, loyal workers on a production line who have been with the same manufacturer for 40 years will reap no more than those who worked there for four years. In terms of the moral hazard of the scheme itself, it should be remembered that predecessors to FEG were introduced to ensure that employees were not left empty handed by corporate insolvencies.

The Productivity Commission is to be commended for its recommendation that "[t]he *Corporations Act 2001* should be amended to allow the Commonwealth to play a more active role as a creditor" as a result of the Fair Guarantee Entitlement. In line with this, it recommended that the Active Creditor Pilot (ACP) that operated by the Department of Employment and Workplace Relations between 2006 and 2007-2008 should "become a permanent part of the scheme."³⁸ The focus of the ACP differs from that of the AAF: the ACP plays a recovery role for the benefit of creditors³⁹ and the AAF is primarily designed to uncover offences for ASIC to pursue.⁴⁰ Under the ACP, the Department of Employment is subrogated to the rights of employees once advances are made pursuant to FEG.⁴¹ The Department should be properly resourced so that it can fund liquidators to seek recovery from directors personally in appropriate circumstances.

Finally, the Productivity Commission asks whether veil piercing might be an option to deal with illegal phoenix activity in corporate groups.⁴² It has requested information about the costs and benefits of the New Zealand and Irish models of contribution orders, where courts can order solvent group members to contribute towards payment of the insolvent company's debts. Veil piercing is an important question deserving a thorough analysis, and decades of scholarly debate have not yielded an unequivocal answer either way. While there are obvious benefits in making group companies liable for the debts of insolvent subsidiaries where there has been deliberate illegal phoenix activity, the rights to recovery of those solvent companies' creditors should not be forgotten.

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³⁶ Australian Government Productivity Commission, n 1, pp 375-376.

³⁷ Australian Government Productivity Commission, n 1, p 375.

³⁸ Australian Government Productivity Commission, n 1, Draft Recommendation 15.7, p 379.

³⁹ While the government will be the primary beneficiary of any recovery, by virtue of the priority status of the employee rights to which the government is subrogated, any excess recovery will be available for the pool of non-priority unsecured creditors including the Australian Taxation Office.

⁴⁰ Note that since November, 2012, the AAF has also allowed funding to be sought "to enable the liquidator to bring an action to recover assets where fraudulent or unlawful phoenix activity is suspected": ASIC, n 27, RG109.3 and Section E.

⁴¹ *Corporations Act 2001* (Cth), s 560.

⁴² Australian Government Productivity Commission, n 1, p 384.