Additional discussion paper for the insolvency system roundtable
4 August 2021
on-line only

The roles of the state and the private profession in the insolvency system: do we have the right balance?

Michael Murray & Jason Harris

Hosted jointly by the Australian Academy of Law and the Ross Parsons Centre, University of Sydney

This paper contains some particular comment on the issues to be raised, and on which any feedback would be welcome.

There are five main purposes of the discussion being held on 4 August:

A. To highlight what we say are problems with the current system.
B. On the basis that there are problems, to propose an option for reform, involving the creation of the role of Official Receiver in corporate insolvency.
C. If they are not accepted as problems, or to the degree we say, to at least have the workings of the current system acknowledged.
D. To propose some other refinements to the system
E. To invite responses at any time, and to thank you.

A. Problems with the current system

The context

Jason Harris had written back in 2018 that

> … Australia has a system that is barely supported by the assets of companies that enter external administration, and certainly is not designed to produce meaningful recoveries for unsecured creditors.
>
> The vast majority of insolvency appointments are:
> - MSMEs with little or no assets
> - where the liquidator is paid less than $50,000 (but a large number are paid little or nothing)
> - where there is no secured debt; and
> - where creditors – 92% - receive nothing.

There are comparable issues in personal insolvency.

He also wrote that the figures show that

> Australian corporate insolvencies exist in two very different universes: that of the large mega insolvencies and restructurings (such as Arrium) where there are large amounts of assets and large numbers of creditors; and that of the small firm with few employees, little assets and few creditors who almost always receive nothing.

For the purposes of our session, that division is important. While we have many ideas on reforms of substantive insolvency law – voidable transactions, examinations, moratoria etc - in relation to insolvencies involving substantial assets and complexities, our focus here is more on the MSME sector, and its access to insolvency services. Substantive issues of insolvency law reform will be better addressed if the role of the state is made clear. Our flow chart should be seen in that light.

This is consistent with insolvencies internationally, with the World Bank, UNCITRAL, and INSOL International all recommending focus on MSMEs in the current COVID-19 impacted economic and social environment.

The issues

While insolvency laws were originally applied by officers of the state, they have developed in Australia and comparable jurisdictions whereby they are applied by a mix of private insolvency professionals (IPs) and by the state.

We argue that this mix needs adjusting in that:

- the state does too little and abdicates its proper public interest role, and at the expense of creditors;
- IPs are required to do too much, and to assume tasks properly the role of the state.

In saying that the state does too little, there are two large gaps - in its oversight of the system, including in relation to the large number of deregistered companies that fall outside, and in the provision of a default liquidator role, for which there is presently none in corporate insolvency. And we say there is an abdication of the state's proper role in investigating and pursuing misconduct, which at present is largely conducted by the IP in corporate and personal insolvency, and mostly funded by creditors.

In saying that IPs do too much, we are seeking to relieve IPs from the need to pursue public interest investigations and refer offences, and from assetless estates. We also say that many of the laws of insolvency need revisiting, and streamlining, including by way of adoption of IT and AI. There may also be a need for the purposes of insolvency to be re-assessed.

At present, as we say in *Keay's Insolvency:*

> We expect the insolvency practitioner, in applying the regime, to act as a protector of the insolvent company or individual, as an asset recovery agent and asset protector, a commercial investigator and problem solver, a public inquisitor, and then, as needed, a distribution agent. These tasks involve the practitioner acting in the inherently competing interests of the insolvent, the creditors and the community. And most significantly, the practitioner is expected to do this with limited or, in some cases, no funds, or where funds are available, in the knowledge that these expenses compete with funds which the creditors might see, unrealistically, as theirs: [1.170].

We argue for a mix of roles. That is, we don't say that the nature of insolvency is such that IPs should have no role, noting however that the NZ Official Assignee is the sole bankruptcy trustee. At the same time, we say it is not satisfactory that Australian IPs have the sole role in corporate insolvency, which leave the gaps we referred to.

We say that IPs should be permitted to apply their skills unhampered by certain features of the current regime and assisted by new features.

The Courts

We do not at this stage suggest any changed role for the courts, to which access would remain, for debtors and creditors and other relevant party. We do have in mind a review of the need for court and creditor sanction of some decisions of an IP, and for a greater alignment of the role of the court between personal and corporate insolvency.

B. Our proposal for an Official Receiver

We will be offering a model to operate alongside the existing system, but with necessary connections, by way of an Official Receiver role in insolvency, with a central gateway registration for all insolvencies. A 'triage' process would be applied to insolvent entities to

determine their allocation according to criteria, either to the OR or to an IP, with the OR pursuing any public interest inquiries. The IPs would be central to the conduct of the administrations with assets and prospects. The finalisation would be the responsibility of the OR. The attached insolvency flow chart will assist in explaining this.
Hence, most existing processes – bankruptcy, liquidation, voluntary administration - would remain, including the role of the courts. Most assetless estates would be resolved promptly. Investigations would be the role of the OR.

Proper role of the OR

That leads to the question as to the proper role of the OR and what should be the dividing line between its tasks and what is expected of IPs. We see that being resolved, at least in some ways, in having the state assume its proper role. This task should be guided as explained by Paul Heath QC, that:

insolvency's "private functions should be performed by the private sector and paid out of funds otherwise available for distribution among creditors, while public functions should be performed by public officials and paid for out of public funds …".

That is, there is assetless and public interest work in an insolvency that should be done only by an OR, and any cost of this should not be borne by creditors, it should be borne by the community. But it should be cost recovered. There are several cost recovery mechanisms, but which we don't address here.

As to what are private and public functions, we accept that, given the wide purposes of insolvency, these functions are not necessarily clear in many cases, and that must be accepted. We have left open the criteria by which that would be assessed. But as one example, it is clear that the present law requiring IPs to investigate and refer misconduct requires the performance by IPs of what are clearly public functions. This is a product of history and of the origins of the role of liquidator. We consider these should be attended to by the state. The roles of the OR in the UK and Singapore, and of the Official Assignee in New Zealand, offer useful ideas.

Are some or many tasks really required?

That should call for a re-assessment of what tasks are in fact required. That is, not only is there a need to reallocate or readjust roles, but the underlying tasks, whether of the state or the IP, need to be addressed. The law requiring an investigation and referral of misconduct, under s 533 CA, requires an IP to investigate and report all offences to ASIC in relation to the company – close to 20,000 offences were reported to ASIC in 2018-2019.

Section 533 is an example of a section that needs change because it is based upon a presumption or connection of insolvency with misconduct or offences, which is, or should be, a remnant of the past. In response to the reality that many offences are reported, one could suggest that any solvent trading company, if subject to the same scrutiny required under s 533, would produce similar results.

There are other examples. One may be contentious, also discussed below, namely that we consider too much focus is given by the law to creditors. In 95% of estates, creditors receive no dividend. In that respect, their 'disengagement', commonly the subject of concerned comment, is understandable. The tasks of an IP in advising, informing and reporting to creditors is considerable, being basic tasks in any insolvency. To a large extent the use of IT could reduce that, but we are far from that at present.

We don't offer a full study of what other tasks should be reassessed, only that there should be a review.

C. If they are not accepted as problems, or to the degree we say, to at least have the workings of the current system acknowledged, and other responses, if any, considered.

In our discussion paper of 22 July 2021, we set out a series of legal or factual issues that we say highlight the problems. If reform is not seen as required, then we would like some acknowledgement that the issues we describe exist and are acceptable. In our view, the following do not appear much in the insolvency law reform debates at present.

There is not enough money remaining in insolvent estates to fund the system in the present fashion

As we opened, we consider that Australia has an underfunded insolvency system. That is, 92% of external administrations pay no dividend returns, deeds of company arrangement return 5.4c on average; in bankruptcy, dividend returns are around 1.2c with 2.53c for registered trustees, and 0.91c for the Official Trustee. Many bankruptcies arise out of MSMEs.

This is a central point. When the numbers are added up, it seems clear that there is simply not enough money in the system to fund liquidators, or trustees, let alone give any return to creditors. The system needs to be changed.

We note that the Harmer Report's recommendations for an Assetless Companies Fund supported by way of an annual charge on companies as part of the price for enjoying the status of limited liability entities was never implemented. There is much to be said for what should be a small fee to cover not only the registration of companies, but also their demise. We point out that New Zealand partly funds its IP regulation process by way of a NZ$1 fee on new company registrations.

We emphasize that none of this is to say that some estates don't produce higher dividends, even 100c/%, and we are not seeking to disturb the existing regime whereby those outcomes can be achieved.

A 2013 study showed that liquidators conducted unfunded work in external administrations to the value of over $48m annually. In 2019, ARITA claimed this figure was $100m.

That has been the traditional model, studies going back to the 1980s quantifying the unpaid work done in court appointed liquidations at 70% of estates. Only recently have similar patterns in bankruptcy been revealed. As we argue, these unfunded costs are recouped ultimately from creditors.

Are there other options?

One is to see IP remuneration as being taken on a 'portfolio' basis – that is, IPs accept a group of matters and attend to them all, including any unfunded, and set their rates accordingly. That could properly allow a high commission fee rate to be set. The US may offer some useful options.

There are behavioural dis/incentives in how remuneration is set that would have to be considered.

Fewer assetless companies being liquidated

The removal of the official liquidator role in 2017, which was inadequate in any event, led to a government policy of accepting that more companies would be deregistered by default,

unless creditors were willing to fund the liquidation. It assumes that IPs accept that they would not take appointments "without some form of guarantee or where they do not believe they are likely to be remunerated".

Default de-registrations under s 601AB average close to 60,000 annually; s 601AA de-registrations average 78,000 pa.

Creditors' and employees' options would be left "to fund the company's liquidation themselves if they hope to recover anything of what they are owed, and risk further losses if it eventuates that company has no assets". Their willingness to do this can be assumed to be limited.

It may be said AFSA has just released that this does not matter. Creditors recover little or nothing from liquidations anyway. Employees can prompt ASIC to pursue its winding up powers, under s 489EA, though noting that ASIC wound up only 7 such companies in 2019-2020.

And it may also not matter that there are large numbers of abandoned companies deregistered by default, under s 601AB, despite academic research by Anderson saying there is a risk of "deregistration becoming the black hole of directors' misdeeds and unpaid debts, through phoenix activity or otherwise".

This issue could therefore be left to 'the market' - to creditors, including the ATO, who can apply to reinstate a deregistered company, and to the laws that seek to counter phoenix activity?

AFSA's 2020 remuneration report showed that 31% of estates handled by private trustees were unfunded

What is unusual about this, apart from the incidental way it is reported by AFSA, is that there *is* an OR in personal insolvency, which takes assetless estates. AFSA has a process of handing out to private trustee estates to which it has consented which have assets or the prospects of them. In the end, those prospects are not met in 30%+ of cases, again, putting the costs either on to the IPs themselves and then, presumably, through to their 'paying' estates and those creditors. On top of that, the trustee is required to investigate and report offences.

AFSA has just released new process guidelines, and it could be said that this concern should be left in the hands of registered trustees to assess what estates they take from AFSA.

Liquidators refer over 19,000 of breaches of the law etc to ASIC each year. Bankruptcy offences are the third highest in the Commonwealth

ASIC's 2018-2019 insolvency statistics listed 7,498 reports lodged by IPs with ASIC, reporting 19,985 possible breaches. The top three were s 588G insolvent trading, s 180 care and diligence, and ss 286 and 344 obligation to keep financial records.

This has been the subject of continued comment for some time, in particular as to the limited response from ASIC to these referrals by way of prosecutions etc.

Objectively, ASIC could not be expected to respond to referrals of that number. But it does monitor the types of offences referred and this informs law reform. One response could be to re-assess what 'offences' should be reported, with some test of materiality. This has been done in New Zealand, as to the obligation to report 'serious problems'. Another would be to have offences reported on an exception basis.

It seems to have become in any event a routine exercise, particularly where there are no remaining funds to cover the cost.

As to AFSA, we also note that, partly as a result of work done by private registered trustees, in 2019-20, charges under the Bankruptcy Act were the *third* highest in number under Commonwealth law, well above the Corporations Act, and the Taxation Administration Act; and that AFSA was the fourth highest referrer.

Others

There is more to be done to address the problems we identify. Much of insolvency practice is rooted in 19th century perceptions and processes. The focus of insolvency has changed, and the measures to deal with it need review.

D. To propose some other refinements to the system.

As an overall recommendation, an insolvency system does not operate in a vacuum, and its effectiveness is much impacted by the infrastructure in which it operates. We favour transparency, disclosure and open and public access to information. In particular, the financial impost on in being required to pay for access to corporate and bankruptcy records of the state should be removed.

We don't address that or any of these suggestions in any detail, beyond listing some of them.

- Open public access to bankruptcy and corporate data, as in the UK and NZ.
- Director identity numbers, which are being introduced, but the detail needs to be assessed.
- Insolvency statistical collection, and analysis. This was an unmet recommendation of the 2010 Senate inquiry into insolvency. Lack of data hampers any consideration of insolvency reform.
- Disclosure of insolvency litigation outcomes - that is, for example, the costs vs financial outcomes, and the impact on creditors. We have limited data from AFSA that trustees' litigation outcomes contribute only a small percentage of total funds realised - $13.5m out of total receipt of $285.5m in 2018-2019.

Other suggestions are invited.

As Paul Heath concluded in his 1999 article, 'remaining issues of insolvency law reform will be better addressed if the role of the state is clear'.

E. Thanks

This is an on-going project the findings of which, and recommendations, are proposed for publication. We have made many comments about these issues on our respective websites www.murrayslegal.com.au and www.australianinsolvencylaw.com

We invite comment at any time.

Thank you for attending and contributing to this project.

Michael Murray m 0402 248 353 e michael@murrayslegal.com.au
Jason Harris m 0437 113 554 e jason.harris@sydney.edu.au

2 August 2021