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29 November 2022

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

By email: seniorclerk.committees.sen@aph.gov.au

Dear Senior Clerk,

**Submission to Parliamentary Joint Committee on Corporations and Financial Services inquiry into corporate insolvency in Australia**

CPA Australia represents the diverse interests of more than 170,000 members, working in over 100 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

Business closure is a necessary part of the business cycle. We support access by all business and creditors to robust corporate insolvency legislation that is equitable and provides mechanisms for businesses to reinvest capital in the economy.

Business should be encouraged to have conversations with their accountant or other trusted adviser early in the wind down phase of their business. This can lead to better outcomes for the business, its employees and creditors. Businesses who can restructure and utilise existing legislation such as Voluntary Administration or Small Business Restructure (with our recommended modifications) can save jobs, reduce government expenditure through the Fair Entitlements Guarantee and provide better returns to creditors, including the Australian Taxation Office. Legitimate businesses that can't restructure should be able to liquidate their affairs quickly and efficiently.

Our response to the terms of reference are included in the **Attachment**.

If you have any queries regarding CPA Australia's ongoing engagement on these matters, please contact Kristen Beadle, Manager, Professional Standards and Business Support on 0413 883 581 or kristen.beadle@cpaaustralia.com.au.

Yours sincerely,

**Dr Gary Pflugrath FCPA**

**Executive General Manager**
**Policy and Advocacy**
**CPA Australia**

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

COVID-19 necessitated some bold and creative policy responses to support otherwise viable businesses. Some of those policy responses led to sharp drops in insolvencies and restructuring. Moratoriums on insolvency laws, government stimulus by way of cash injections into business, rental relief schemes and soft approaches to debt collection by the ATO, major lenders and state revenue authorities all contributed towards some of the lowest insolvency levels for some time. Our members tell us that these pandemic-related measures allowed some businesses to trade on when they would normally have wound up their affairs.

However, business exits, including insolvency, is an essential part of an efficient and effective economy. The Productivity Commission's interim report titled "5-year Productivity Inquiry: Innovation for the 98%" states *"…business exits and entries underpin the entrepreneurial culture and uptake of innovations, and shift resources into activities more likely to generate value and productivity."* Australia's insolvency laws should embrace these aspects of the business cycle to support improvements in productivity.

Insolvency rates have increased in 2022 and are back to pre-Covid–19 levels. However, these rates are still low. Given the approaches undertaken during the pandemic, we cannot say with certainty whether these increased levels are a result of current economic conditions or a market correction. Members are telling us that skills and labour shortages, the high costs of labour, supply chain disruptions and high inflation is impacting business profitability and performance. Many existing business models are not equipped to deal with high inflation and/or high wage environments. This is particularly apparent in sectors, such as building and construction, who work on fixed price contracts and who may not be able to pass on increased costs to consumers.

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

***Small Business Restructure***

The Small Business Restructuring ('SBR') reforms have improved the ability of small to medium businesses ('SME') access to insolvency laws without losing the goodwill of the business that may result from liquidation. However, uptake is very low. Members are telling us that operationally there are some unintended consequences of the legislation that may be inhibiting access by SMEs. For example, members report that:

- companies who utilise this legislation may lose insurance cover, which is vital to ongoing operations, especially in sectors subject to separate regulation, such as building and construction.
- clients who undertook a SBR had their merchant facilities cut off by their bank.
- Australian Securities and Investments Commission ('ASIC') records shows that a company going through an SBR is 'under external administration', which is misleading as to the solvency/viability of the company.

We propose that the Committee considers the following SBR reforms:

- A review of the current $1million liabilities threshold. Registered Liquidators are suggesting that this amount should be increased to enable greater access to this legislation.
- The eligibility to undertake a SBR allow for outstanding superannuation to be brought up to date as a priority under the Plan, rather than a condition of access to the legislation.
- Removal of the act of insolvency from Section 455A(2) of the Corporations Act 2001 (the 'Act') and amend the Act to indicate that the act of insolvency should be if the terms of the Plan are not made.

Feedback from our members indicates that operationally, large institutional creditors such as the ATO, are placing an investigatory burden on a Small Business Restructuring Practitioner ('SBRP') similar to the investigatory requirements of a Voluntary Administrator. We see this as being outside of the legislative scope of the SBRP and recommend these large institutional creditors adhere to the requirements of the legislation. This type of expectation by creditors such as the ATO increases the costs of the SBR process.

Related to the above point, it should be noted that becoming a SBRP does not require the same levels of experience and knowledge that a fully licensed Registered Liquidator must have. Requiring such information and analysis from a SBRP is outside the practitioner's experience and/or licensing requirements. Should this type of creditor behaviour continue, we would recommend that only fully-qualified Registered Liquidators undertake SBR appointments.

***Illegal Pheonixing***

Presently we cannot determine the adequacy of the unlawful pheonixing laws introduced in 2019. These reforms were only briefly operational prior to the pandemic. We therefore don't have sufficient data or case law (with only one known case to date) to determine its operational adequacy or functionality.

There is currently inadequate formal education available to directors for them to understand their responsibilities under the Act. We consider that the current practice by business owners of intermingling their corporate and personal affairs should be addressed as part of this review to address this knowledge shortfall. This educational requirement should be funded by directors and not be an impost on insolvency practitioners.

CPA Australia supports the introduction of director IDs as part of the Modernising Business Registers program. This is an important step towards reducing illegal phoenix activity. We wish to see government invest into this functionality and expand the useability of the information which will enable Registered Liquidators and the broader public to utilise this information, to determine with whom they are doing business.

Members have informed us that illegal pheonixing may occur when a business owner is faced with a lack of viable options. For example, businesses in the building and construction industry have limited options to restructure viable businesses due to state-based barriers to accessing the SBR or Voluntary Administration (VA) process. These regulatory barriers mean that certain viable businesses that could potentially restructure with the agreement of creditors cannot do so – leaving insolvency (and lost jobs and potential entitlements) as the only outcome. We recommend that the federal government works with the states to remove barriers to accessing SBR and VA. This ensures all businesses are on a level playing field and that laws don't inadvertently encourage illegal phoenixing.

## 3. Other potential areas of reform

***Trusts***

Members have informed us that the current conflict between insolvency and trust laws are one of their main areas of concern. The current regime has increased the need for Registered Liquidators to make court applications to seek an appointment as receiver over trust assets, to realise assets by the right of indemnity for the benefit of creditors. We recommend an introduction of an *Ipso Facto* prohibition into the Act which states that in the event of an insolvency of a corporate trustee, that corporate trustee retains its right to act as trustee of the trust. This will ensure that the Registered Liquidator appointed over the corporate trustee can realise assets for the benefit of creditors whilst adhering to the provision of the trust deed. In this regard, the Registered Liquidator will hold a dual role as the external administrator to the corporation and as trustee of the trust. This would reduce costs and hasten the insolvency process.

Additionally, we recommend that as part of the modernisation of business registers that there be disclosure of the capacity of a corporation, whether it is acting in its own right, as trustee of a trust, or both. We believe this will assist in full disclosure of business-to-business trading activity.

***Safe Harbour***

Presently, there is no publicly available information to determine whether a company has accessed safe harbour provisions. Such information is important to lenders and creditors to determine whether they wish to undertake business with that entity. We recommend that the modernising business register include a notification to the public of this fact.

The government should consult further on the previous government's response to the review of the insolvent trading safe harbour before finalising its view. For example, the response introduces new concepts that are not defined, such as in Recommendation 1, "financial distress". We also recommend that further thought be put into Recommendation 8 with respect to whether it is appropriate for a company to receive advice on a defence to insolvent trading when current legislation does not have a mechanism for a civil or criminal penalty to be issued to a company.

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

There is a widespread perception that insolvency carries with it the stigma of business failure. As the Productivity Commission noted in its recent interim report on innovation (noted above), business churn (business exits and entries) can lead to greater innovation and productivity improvements that benefit the entire economy.

The interim report states "There are worrying signs that some of the principal vehicles for acquiring and transferring knowledge are dormant or slowing… So too has the degree of churn in markets as measured by the generally falling rates of firm entry and exits. This is concerning because business exits and entries underpin an entrepreneurial culture and uptake of innovations, and shift resources into activities more likely to generate value and productivity."

To that end, government and regulators should encourage businesses to seek advice early and often, including exploring what avenues may be available for businesses in distress. CPA Australia advocates for government to provide incentives to business to access advice from their trusted existing adviser, especially in times of financial distress.

The government should therefore consider offering small business an incentive payment to seek advice similar to Victoria's Small Business Specialist Advice Pathways Program.

Members tell us that the earlier a business in financial distress can access this advice, the more likely it can be restructured and remain viable. Unfortunately, financially distressed businesses often seek advice when it's too late, and the business cannot be salvaged. The negative connotations attached to insolvency is not helpful in this situation – and may in fact be leaving business owners exposed to advice from unlicenced and unregulated advisors when they are most in distress. We recommend that business be given the right tools and messaging that seeking professional advice for their business is a positive experience and should be encouraged.

## 5. The role, remuneration, financial viability, and conduct of corporate insolvency practitioners

Registered Liquidators have positive obligations under the Act to undertake minimum prescribed tasks. This means, regardless of whether there are sufficient funds available, the Registered Liquidator must undertake those tasks to fulfill their duties under the Act. This is different to any other accounting service or other professional service providers, such as lawyers, who, if their fees are not paid, can walk away from the engagement.

Additionally, a Registered Liquidator will assume personal liability for the administration of the client, meaning that if realisations are insufficient, the Registered Liquidator is personally liable for any shortfall. Registered Liquidators tell us that on average, they will write off 50 per cent of work in progress for clients. Many of our members who are Registered Liquidators run small businesses themselves, who are often not remunerated adequately for their time or are only paid for their time months after their service was provided. We note that the perception of Registered Liquidators being highly remunerated is often not the reality.

Section 556 of the Act sets out the order of priority for payments to be made in an external administration. The difficulty arises when large institutional creditors or state laws in effect prohibits a Registered Liquidator from being renumerated for work properly performed. By way of example, section 561 of the Act provides for payment to employees from assets subject to a circulating security interest. We support the priority of payment of employee entitlements. We do note that at present, Registered Liquidators are NOT being remunerated for their work to realise these assets for the benefit of the employees' priority as the Fair Entitlements Guarantee is claiming full entitlement to the monies without consideration to the risk and exertion our members undertake in their role as a Registered Liquidator to realise these assets.

We submit that this is an unintended consequence of the legislation, and that Registered Liquidators should be able to rely on section 556 of the Act and the associated case law for their order of priority for payment. Without addressing the proper remuneration and surety of payment of Registered Liquidators, we foresee it impacting the ability of companies and creditors to access the qualified and regulated insolvency advice they need.

## 6. The role of government agencies

***Australian Securities and Investments Commission ('ASIC')***

We refer to the report issued by the Financial Regulator Assessment Authority ('FRAA') "Effectiveness and Capability Review of the Australian Securities and Investments Commission" published in July 2022. We support the view that ASIC should embrace enhanced digital technology to provide meaningful data for the modern economy.

Registered Liquidators have a positive obligation to report to ASIC the causes of company failure. At present, ASIC's systems do not collect information such as cyber security breaches as a cause of insolvency, as part of the required reporting under section 533. We recommend that ASICs systems enable insolvency practitioners to report on more meaningful information on company failure. We further note that the cost of any upgrade to ASIC technology and systems should not be borne by its regulated populations.

We also agree with the FRAA recommendation at paragraph 3.106, which recommends that ASIC engages stakeholders appropriately when setting its strategic priorities. We note that ASIC has engaged with CPA Australia on areas such as Cost Recovery Implementation Statement. However, we would welcome ASIC further engaging with us on a more meaningful level earlier in the process. Currently, we perceive that ASICs stakeholder engagement occurs after decisions are made and is part of a 'tick-the-box' exercise rather than an attempt at genuine engagement.

*Assetless Administration Fund*

Due to the obligations of Registered Liquidators to report offences under the Act to ASIC, it is imperative that in circumstances of insufficient assets to pay for such an obligation, that the Registered Liquidator is remunerated for their exertion.

The task of investigating offences and collecting evidence of offences serves an important function in the economy and in protecting creditors. Registered Liquidators should be viewed as the gate keepers of the economy. Without adequate funding of the Assetless Administration Fund, these offences may not be prosecuted by ASIC. This funding should be seen as an investment in compliance by directors, who would then be seen as upholding their obligations and duties.

We are disappointed that the budgeted increase in funding for the Assetless Administration Fund was redirected to other priorities in the October 2022 budget. We need the government to appropriately fund a robust insolvency system which enables those charged with ensuring stakeholders are complying with their obligations to be appropriately funded to undertake these tasks. We recommend that the government reinstate the proposed funding increase of the Assetless Administration Fund in its 2023 budget.

## 7. Any related corporate insolvency matters

We recommend a more robust company deregistration process, linked to director IDs, as part of the Modernising Business Register. Presently there are minimal checks and balances in place to protect creditors against voluntary deregistration of a company who may owe creditors an outstanding debt. We recommend that ASIC implements more stringent processes in deregistration to ensure companies with outstanding debts cannot voluntarily deregister. We recognise that deregistration is a separate process to a Members Voluntary Liquidation ('MVL') which is a distribution of capital to shareholders. We do not recommend any changes to the MVL process.

We also recommend that ASIC liaises with the accounting profession on the financial literacy of company directors. CPA Australia has recently worked closely with Government departments, such as the Department of Agriculture, Fisheries and Forestry to provide educational tools for members and the greater public on the Shared Responsibilities in Drought Support.