Submission for Inquiry into Corporate Insolvency in Australia

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Date: 29 November 2022

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Executive summary and recommendations

Australian corporate insolvency law is failing the small businesses that are at the heart of the Australian economy. The 'General Insolvency Inquiry' of 1988, and subsequent law change in 1993, introduced Voluntary Administration — a form of restructuring which has been completely ineffective in turning around insolvent small businesses.

In 2021, a positive development came with the introduction of the Small Business Restructuring Practitioner (SBRP) framework. There needs to be further improvements to the SBRP framework, as well as other changes to the corporate insolvency framework that would better support small to medium-sized enterprises (SMEs).

The problems with the current system begin with the purposes or objectives that underlie the corporate insolvency framework. The current focus is risk-based and punitive — directed at the small number of business directors that engage in misconduct, rather than the majority who would be better described as overwhelmed by financial distress.

The corporate insolvency system must shift towards supporting businesses capable of turnaround, and quickly winding up businesses that are not economically viable.

A major difficulty in assessing the existing corporate insolvency framework is the lack of detailed data released by official actors into the operation of the system. For example, creditors should be provided with a breakdown of how liquidators spend their time (and therefore spend company assets), and the Australian Securities & Investments Commission (ASIC) should release more detailed information on the root causes of insolvency.

Currently, the corporate insolvency framework applies a 'co-regulatory model', where both ASIC and the Australian Restructuring, Insolvency and Turnaround Association (ARITA) play key roles. It is inappropriate for ARITA to play this role, as they lack the impartiality to make decisions in the public interest, rather than simply the interests of their membership (predominantly registered liquidators).

Voluntary Administration is an expensive (around $50,000 per administration), and largely unsuccessful, restructuring mechanism (around 1 percent of insolvent companies use Voluntary Administrations to successfully restructure). While it has worked for some larger corporates, it is ill-suited to SMEs. Instead, the SBRP framework should have its scope extended to cover a larger proportion of Australian companies (a $5m limit on total liabilities up from the existing $1m cap).

Any reform of the corporate insolvency framework needs to re-think the role of insolvency practitioners. The current monopoly held by registered liquidators (and in essence, professional accountants) needs to end. Successful business restructuring requires more than just accounting skills, and there ought to be extra emphasis on general business skills.

There should also be a mechanism allowing directors to receive more robust insolvency advice, prior to an external administration commencing.

Finally, the way in which insolvency practitioners charge for their services needs to change. The dominance of the 'hourly rate' incentivises incompetence, and provides no motivation for insolvency practitioners to achieve a desirable outcome for an insolvent company. Instead, insolvency practitioners should be paid based on a 'percentage of assets'.

I recommend:

1. A re-organisation of Australia's corporate insolvency framework to reflect the fact that the wider economic interests in business turnaround and efficiency should guide each element of the legal and regulatory framework.
2. That the corporate insolvency framework recognise that the needs of financially distressed small-to-medium sized enterprises (SMEs) are distinct from large corporates.
3. That ASIC be directed to provide more detailed information about both individual insolvent administrations and the performance of the system as a whole.
4. That reform to liquidator reporting require that liquidators provide more detailed breakdowns of their fees and costs to creditors.
5. Transfer of government oversight of SME corporate insolvency to the Australian Financial Security Authority (AFSA).
6. That the Australia Restructuring, Insolvency and Turnaround Association (ARITA) be removed from involvement in registration and disciplinary actions against insolvency practitioners.
7. A requirement for general business skills for those seeking registration as an insolvency practitioner.
8. The current SBRP upper limit be lifted from $1 million in debt to $5 million.
9. For Voluntary Administration itself, that the process be streamlined.
10. That there be increased transparency and reporting around the costs of Voluntary Administration.
11. Recognition that insolvency practice does not meet the expected norms of a profession, and therefore insolvency practitioners should not be (largely) self-regulating.
12. Recognition that liquidators and Restructuring Practitioners should have different skill sets.
13. Opening the criteria for insolvency practice in general to enable and encourage non-accountants to enter the field, and especially to become Restructuring Practitioners.
14. A clear separation of restructuring and liquidation roles.
15. Empowering insolvency practitioners to advise on insolvency matters before appointment, but require that advice to be put into writing as a condition of appointment.
16. Encouraging the development of a turnaround profession (as distinct from registered liquidators).
17. That pricing structures be regulated to move to a 'percentage of assets' model.
18. Revamping the insolvency practitioner complaints process.

19. Introducing a proper funding model for assetless administration to avoid cross-subsidy.

Introduction

1. I appreciate the opportunity to provide a submission to this Inquiry into the effectiveness of Australia's corporate insolvency laws (the Inquiry), initiated by the Parliamentary Joint Committee on Corporations and Financial Services (Committee) on 28 September 2022.

2. Sewell & Kettle are a specialist insolvency law firm and the firm has a single goal, which informs this entire submission: To turnaround Australian businesses in financial difficulty and minimize financial ruin and insolvency for small-to medium-sized enterprises (SME), their owners and their directors.

About Ben Sewell

3. This submission is written by Ben Sewell, principal of the firm, and an expert in insolvency law and restructuring. I was admitted as a solicitor in 2002 and I developed a specialization in providing holistic advice and solutions to help support businesses in financial difficulty.

4. Over the years, I have represented SME clients in the NSW, Victorian, Queensland and Federal Courts. I have also been involved in insolvency policy development with the NSW Law Society, published on insolvency law in journals, and given master classes and seminars to insolvency professionals and lawyers around Australia.

5. I hold a Master of Laws in Corporate & Commercial Law and a Master of Business Administration. I also hold a public practice certificate as a Corporate Reconstruction Accountant to ensure that I am able to provide holistic advice about the financial circumstances of distressed businesses.

About Dr Drew Donnelly

6. In this submission, I am assisted by Dr Drew Donnelly, a long-time researcher at Sewell & Kettle. Dr Donnelly has worked as a regulatory specialist in the public and private sectors for the past decade, advising senior stakeholders (including CEOs, directors and cabinet ministers) in fields as diverse as education, financial services and insolvency policy.

7. Dr Donnelly holds a PhD in Philosophy from the University of Sydney, as well as a Bachelor of Laws and a Postgraduate Certificate in Public Policy. He is an enrolled Barrister and Solicitor of the High Court of New Zealand (non-practising).

Structure of this submission

8. With reference to the Terms of Reference (ToR) for this inquiry, I will address the following, with specific reference to SMEs[1]:
    a. the small business restructuring reforms (2021) (ToR, clause 2(a))
    b. the safe harbour from insolvent trading (ToR, clause 3(c))
    c. supporting business access to corporate turnaround capabilities to manage financial distress (ToR, clause 4)
    d. the role, remuneration, financial viability, and conduct of corporate insolvency practitioners (being registered liquidators) (ToR, clause 5)
    e. the role of government agencies in the corporate insolvency system (ToR, clause 6).
    f. The concept that underlies this entire discussion: The purpose (or purposes) of the corporate insolvency regulatory framework in Australia (clause 7).

9. In addressing these matters, my submission will be organised around the following questions, and in the following order:

    - Part A: What is, or should be, the purpose of the corporate insolvency regulatory framework in Australia?
    - Part B: Is there any evidence that the current corporate insolvency regulatory framework works?
    - Part C: Does Australia have a co-regulation model for corporate insolvency?
    - Part D: How does Voluntary Administration compare to small business restructuring as a business turnaround mechanism?
    - Part E: What is, or should be, the role of insolvency practitioners?
    - Part F: Who should give advice before appointment?
    - Part G: How should insolvency practice and restructuring be priced?

Part A: What is, or should be, the purpose of the corporate insolvency regulatory framework in Australia?

A brief history of corporate insolvency regulation

10. To understand the purpose of current corporate insolvency regulation, it is necessary to understand where that law has come from and how it has evolved over time.

11. Insolvency — the inability to pay debts as they fall due and payable — has long been regulated in some way, whether by law, custom, or by way of religious obligation.

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[1] A small business is defined by the Australian Bureau of Statistics (ABS) as a business with 0-19 employees, A medium sized business is defined by the ABS as a business with 20-199 employees

For example, within Judaism, the Torah commanded that every seventh year is a sabbatical year where the debts of others in the Jewish community are forgiven. Some fundamentals of modern insolvency law were already settled during the period of Roman Law: This includes the forfeiture and sale of property to pay debts, and the idea that each creditor should be paid *pari passu* — in proportion to what they are owed.

12. While the modern corporate form, the private limited company, did not arise until the 19th century, modern corporate insolvency has its origins in older English laws of bankruptcy (i.e., personal insolvency). The first law on bankruptcy (the Statute of Bankrupts, 1542), affirmed the principle of *pari passu*, but also made available harsh punishments for the bankrupt, including powers for the Lord Chancellor to imprison the debtor and distribute their assets.

13. The first sign of liberalisation in the process occurs in 1705 with a new process allowing a bankrupt to be discharged under very specific circumstances. Arguably, the ability for a bankrupt to discharge debts is the cornerstone of any modern framework for insolvency: Processes which allow an individual or business to extinguish the claims of existing creditors and start their business afresh.

14. The law relating to *corporate* insolvency evolved organically in the UK, alongside the growth in the private limited company as a common business structure. One key milestone was the Limited Liability Act 1855. This statute expressly allowed ordinary individuals in England, Wales or Ireland to set up a limited liability corporation. From this point on, shareholders were only liable for company debts to the extent of their shareholding. Concerning this proposed law, in the House of Lords, Earl Grey (formerly the Colonial Secretary and Legislative Council Member for New South Wales) observed:

    > *"It proposes to depart from the old-established maxim that all the partners are individually liable for the whole of the debts of the concern."*[2]

15. In short, the rise of private limited companies meant that the company could go insolvent and be liquidated, without automatically creating a personal debt against the shareholders and directors. From this point on, personal insolvency law and corporate insolvency law were clearly distinguishable. Throughout the 19th century there is still little evidence of any genuine business turnaround alternatives to a standard liquidation (while the Insolvency Act 1861, did introduce 'deeds of arrangement', these were still a way of winding up the existing business).

16. In the 20th century, both in the UK and Australia, the law has slowly changed over the years to recognise the benefits of business turnaround over liquidation and deregistration.[3] Up until 1993 this was reflected in Australia in 'Schemes of

[2] https://hansard.parliament.uk/Lords/1855-08-07/debates/264345d6-96fc-4671-a258-7e3537ca2f7d/LimitedLiabilityBill.

[3] For detailed histories of the development of Australian insolvency law see 'The evolution of bankruptcy and insolvency laws and the case of the deed of company arrangement', James Edelman, with Henry Meehant and Gary Cheung, 2019 Oxford Law and Finance Distinguished Speaker Series, University of Oxford, 14 January

Arrangement' (an expensive, court-supervised process only feasible for very large corporations) and Official Management (an unpopular, court-supervised predecessor to Voluntary Administration).

17. 1988's General Insolvency Inquiry[4], and subsequent law change in 1993, introduced the first popular formal restructuring mechanism into Australia law: In *Voluntary Administration* an independent insolvency professional (being a registered liquidator) is appointed by directors to take charge of an insolvent company and work towards a debt compromise with creditors (a 'Deed of Company Arrangement' or 'DOCA'). If no such debt compromise is successful, the company is generally liquidated/wound up. Unfortunately, this reform did not differentiate between large corporates and small to medium-sized enterprises (SMEs) (a 'one size fits all model'). This was short-sighted and resulted in the same process being applied to large corporates (such as Ansett Airlines and Virgin Airlines) and the SMEs that Sewell & Kettle typically represents (for example, construction and transport companies with up to 199 employees).

18. I argue later that, in retrospect, a streamlined procedure should have been applied to SME restructures from the beginning. In light of this, the new small business restructuring process is a sensible reform, which I would like to see extended further.

19. Further law changes over the last decade opened up new avenues for insolvent corporate restructuring:

    - In 2017, the introduction of an 'insolvent trading safe harbour' to the Corporations Act 2001 (Cth) made it easier for directors of insolvent companies to attempt an informal restructure of the company. This new section 588GA of the Corporations Act 2001 (Cth) gives company directors 'breathing room' to come up with a plan to turn the company around, without being personally liable for allowing the company to trade while insolvent. This new safe harbour is more useful for larger corporates because they have access to better advisers and more complete financial controls.

    - In 2021, with the introduction of the Small Business Restructuring Practitioner (SBRP) reforms, insolvent smaller businesses now have a new formal option for turning the business around. These law reforms mean that directors of small businesses can remain in control of their company, while an independent, qualified professional (the 'Restructuring Practitioner') helps to

2019. Available at https://www.hcourt.gov.au/assets/publications/speeches/current-justices/edelmanj/EdelmanJ14Jan2019.pdf. See also 'The Historical Development of Insolvency Law', by the Hon T F Bathurst, Chief Justice of New South Wales, for the Francis Forbes Society for Australian Legal History, 3 September 2014. Available at https://www.supremecourt.justice.nsw.gov.au/Documents/Publications/Speeches/Pre-2015%20Speeches/Bathurst/bathurst_20140903.pdf.

[4] Also known as the 'Harmer Report', see https://www.alrc.gov.au/wp-content/uploads/2019/08/alrc45_Summary.pdf.

develop a plan for turning the company around ('the restructuring plan'). This process is faster, more streamlined and cheaper than Voluntary Administration. It also allows the directors to continue their business trading throughout the process (i.e. it is a debtor-in-possession procedure).[5]

The purposes of corporate insolvency

20. Through English and Australian jurisprudence, and key inquiries over the years, I can discern the following objectives underlying our system of insolvency regulation:
    - Restoring a company to profitable trading
    - Maximising returns to creditors
    - Providing a fair and equitable system for the rankings of claims
    - Identifying the causes of the company's failure and imposing sanctions for culpable management by its directors and officers.[6]

21. As set out in the Corporations Act 2001 (Cth), corporate restructure through the Voluntary Administration regime has attempted to satisfy all of those aims. Views differ on how successful it has been at actually doing so (I discuss my own views in the next Part of this submission). The small business restructuring regime, on the other hand, streamlines the achievable goals (arguably into something more realistic and attainable). I discuss this in more detail below.

22. Why even discuss the purpose of a corporate insolvency regulatory framework? We can't talk about each component of the system (small business restructuring, role of insolvency practitioners etc) without looking at the very purpose of the insolvency framework in Australia. Part 5.3A Corporations Act 2001 (Cth) which governs Voluntary Administration, states that the Object of that part of the Act is to:
    - maximise the chances of the company, or as much as possible of its business, to remain in existence; or
    - if the first option is not possible, achieve a better return for the company's creditors and members than would result from an immediate winding up of the company.

23. In my view, the current framework does not support the first element set out above, and the second one rarely happens. In most cases, in Australia, significant creditor returns are very unlikely. In my experience, the supposed goals of the Voluntary Administration regime is a 'mystification' primarily serving the financial interests of insolvency practitioners, rather than creditors, businesses themselves or the wider economy. I consider this issue extensively in part D of this submission.

24. The SBRP regime brought in an arguably more practical model for the Objects or purposes of the process: According to section 452A of the Corporations Act 2001

[5] For more information, see https://asic.gov.au/regulatory-resources/insolvency/insolvency-for-directors/restructuring-and-the-restructuring-plan/.

[6] *Goode on Principles of Corporate and Insolvency Law*, 5th Student Edition, Van Zwieten, K (2019) Sweet & Maxwell, pages 75-82.

(Cth) the purpose of the Part relating to small business restructuring is to allow eligible companies to:

- retain control of the business, property and affairs while developing a plan to restructure with the assistance of a small business Restructuring Practitioner; and
- enter into a restructuring plan with creditors.

25. In my view, section 452A sets out more attainable business turnaround goals for the SMEs that make up a large portion of the Australian economy. The focus is on the directors remaining in control of their business, and the specific plan to turn it around (restructuring plan). There is no 'poisoning the well' by implying that this is also a way to terminate the business, as the statutory Objects of Voluntary Administration suggest. The objectives stated also take morality out of the equation and focus completely on sensible commercial outcomes.

26. The fact that directors of eligible businesses are able to choose between the two procedures is internationally unusual: I am not aware of any other jurisdiction where an insolvent SME can choose between a debtor-in-possession model (i.e. small business restructuring) and a creditor-in-possession model (i.e. Voluntary Administration) for insolvent restructuring. However, as I will argue later, the smaller asset size and essential personal labour of director/owners mean that a debtor-in-possession model for SMEs is more appropriate, in my view, as a restructuring model.

27. The Australian economy is dominated by SMEs, and thus most insolvencies involve SMEs. The success of the Australian economy also depends on the proprietors being able to get started again in circumstances where many SMEs will fail. It is worth remembering that small businesses in Australia usually make very modest profits — it is the community itself that primarily benefits from the services they provide.

28. Historically, insolvency procedures for SMEs in Australia have been unduly punitive. Does the Inquiry really accept that of the approximately 8000 corporate insolvencies annually, 88% involve possible misconduct, as reported by liquidators?[7] Or, is it not possible that small business failure and poor record-keeping by director/owners is wholly natural and expected?

29. There seems to be something perverse in empowering an army of accountants to criticise small business failure and threaten legal action — legal action that very rarely eventuates, I might add. Even the Marxist historian Mike Davis in his history of Los Angeles attributes much of the economic success of that city on the capacity of small business to fail and then regenerate:[8]

> *This service-heavy economy, based upon a myriad of poorly-capitalized small businesses, is especially vulnerable to fluctuations in economic weather.*

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[7] EXAD ASIC analysis of Liquidator reports 2019, page 2.
[8] Davis, M (1990). *City of Quartz: Excavating the future in Los Angeles*, Verso Books page xii.

> *Indeed both the rate of business formation, and the rate of business failure, remain higher than in most other metropolitan regions. This generates plenty of heartwarming stories about successful ethnic enterprise, but it also ensures an equally high rate of broken dreams and bankruptcy. Too many ethnic donut stores, nail parlours, tiendas, taco wagons, landscaping services, auto repair shops, and hairdressing studios survive only by dint of heroic feats of family self-exploitation. The employees of the micro-enterprise sector, moreover, tend to eke out survival at the barest minimum: caught in a gigantic low-wage, largely off-the-books, economic ghetto.*

30. The most balanced view of SMEs is to value their contribution to the economy, and acknowledge that they do not usually make much of a personal profit. Similarly, it is unreasonable to expect your local café or carpenter to have perfectly balanced books and up-to-date accounting software when they close down due to insolvency. Setting up a system with unrealistic expectations of SMEs and their directors upon insolvency means failure-by-design.

31. It is clear that the models of Voluntary Administration and insolvent liquidation are not based upon an accurate understanding of SME insolvency and its causes in Australia. It is also worth bearing in mind that in the SME space, the regeneration of business proprietors is an economic necessity. For instance, the recent collapses of SME residential home builders means a need for new market entrants to ensure that Australian families of the future have new homes.

32. So which businesses should be restructured and which should be allowed to go into liquidation? Contemporary corporate restructuring theory asserts the following:

    > *Both liquidation and reorganisation are available courses of action in many countries of the world and are based on the following premise: If an entity's intrinsic or going concern value is greater than its current liquidation value, then the firm should be permitted to attempt to reorganize and continue. If, however, the firm's assets are worth more "dead than alive" – that is, if liquidation value exceeds the economic going-concern value – liquidation is the preferred alternative.*[9]

33. I would argue, however, that contemporary insolvency theory is of limited use for the problem that I believe this Inquiry faces — how to better support SMEs in Australia to survive and thrive. The reason is that the *true* value of the average Australian SME is not recorded on its balance sheet because the true value comes from the 'sweat capital' of the SME owner/director. Without this, in fact, most SMEs in Australia are not viable. The economy as a whole benefits and derives significant economic value from the fact that the builder, transport company, retail store, restaurant, etc continues to trade *even though they are not making an economic profit*. These companies aren't Uber or Apple – the owners of SMEs generally pay

[9] Altman, E, Hotchkiss, E & Wang, W. (2019) *Corporate Financial Distress, Restructuring and Bankruptcy*, Fourth Edition, John Wiley & Sons.

themselves a wage only. This means that a more generous system of restructuring SMEs is appropriate when compared to that granted to large corporates.

A step backwards: the rise of the risk model

34. While a positive step, the SBRP scheme is not generally representative of insolvency law changes over the past 20 years. **Instead, a risk- based model has dominated reform**. This means, the emphasis has been on the potential wrongdoing of debtor companies and their directors, rather than business turnaround. Ostensibly, the reason for these reforms have been to ensure market integrity (consider, for example, reforms related to director penalty notices and creditor-defeating dispositions), but they have nevertheless facilitated director punishment and small business closure.

35. This emphasis seems misguided. While there are no official statistics kept directly on the matter, in my estimation, the vast number of companies that go under have no actual dishonesty: And if we look at official ASIC corporate insolvency statistics, what we consistently see is that poor cash control, record-keeping and general management practices are the fundamental causes of insolvency in Australia. These are indications of SME directors who are over-worked and in-over their heads — not persons motivated by malice or fraud. The financial reality is that the small businesses that fail don’t have many assets left anyway, so there is little opportunity to commit fraud.

36. Very rarely do any reported ASIC or liquidator investigations reveal director dishonesty or fraud is involved. I would conjecture that, where possible misconduct is reported by liquidators to ASIC, the misconduct is more ‘of form’ than substance (e.g., a failure to balance the books or ‘keep’ all accounting documentation). Insolvency practitioners in Australia charge on an hourly basis, and there is little accountability for how that time is spent. This means there is every incentive for insolvency practitioners to add hours spent on director investigations and complaints to their bills, even where those investigations come to nothing. I am not claiming that this is what insolvency practitioners actually do — for that we would need far more information than we actually have access to. However, it is clear that the reward/compensation system for insolvency practitioners is somewhat perverse and short-sighted.

37. There is, or should be, only one guiding purpose for all insolvency regulatory frameworks: The wider economic interest in speedy business turnaround, or the redistribution of assets, so that people and capital can get back to work. The Corporations Act 2001 (Cth), alongside the supervision and enforcement regimes for corporate insolvency need to be revised to better reflect this goal.

Recommendations

38. I recommend:

- **A re-organisation of Australia's corporate insolvency framework to reflect the fact that the wider economic interests in business turnaround and efficiency should guide each element of the legal and regulatory framewor**k. Liquidation and winding up should be a last resort reserved for unviable businesses. Relatedly, there is unreliable evidence to justify the current emphasis on the risk of director wrongdoing for SMEs.
- **That the corporate insolvency framework recognise that the needs of financially distressed small-to-medium sized enterprises (SMEs) are distinct from large corporates**. The system of insolvency needs to be more generous to SMEs to encourage continued investment and the contribution of personal labours by proprietors of those businesses. The regeneration of SMEs is a vital part of the Australian economy.

Part B: Is there any evidence that the current corporate insolvency regulatory framework works?

Lack of meaningful data

39. At the surface level, the number of companies going into external administration does not appear problematic. The Australian Securities & Investments Commission (ASIC) oversees over 2 million companies and yet only about 8000-10,000 companies go into external administration (i.e., Voluntary Administration, liquidation, receivership or small business restructuring) annually.

40. But a danger lurks beneath: There are a considerable number of company deregistrations going on every year where the company is likely to be insolvent. These could be voluntary deregistrations (instigated by directors) or involuntary deregistrations (at the instigation of ASIC, but due to non-payment of fees). In the latter cases, this means the company has failed to comply with its obligations in some way (such as paying annual fees) and this is often deliberate. In my experience, many small practice accountants are now recommending that their clients stop paying ASIC annual fees to obtain deregistration by ASIC to avoid appointing liquidators. Prominent insolvency commentator Michael Murray observed that, in the 2014-2015 year, of the 112,714 companies deregistered, only 6.2% or 7,044 companies were liquidated/wound up first.[10] Mr Murray updated this in 2022 to observe that the ratio of companies deregistered (without liquidation) to liquidations rose from 5:1 in 2016 to 13:1 in 2022 (80,735 companies were deregistered voluntarily or by ASIC strike out action).[11]

41. What does this mean? In the vast majority of cases where Australian companies are being terminated (either by voluntary or compulsory deregistration), **we have no idea whether that company was insolvent** or might have been restructured. This is but one example of the difficulties in determining whether existing restructuring

[10] https://murrayslegal.com.au/blog/2020/07/20/company-deregistration-governments-fast-track-response-to-assetless-companies/.
[11] https://murrayslegal.com.au/blog/2022/08/12/16210/.

mechanisms, such as Voluntary Administration, are successful — we lack meaningful data. What is clear is that many small private practice accountants have exploited this anomaly and, instead of recommending a formal insolvency procedure, being "clever" and advocating clients avoid insolvency procedures altogether through the ASIC-initiated deregistration process.

42. The lack of meaningful, publicly released, data means that (a), it is difficult to discern in any particular case whether an external administration was successful and (b), we can't take a birds' eye view and easily assess systemic efficiency: The challenge is micro-economic reform, not swarms of cowboy directors.

43. The recent empirical analysis of phoenix activity carried out by the Phoenix Research Team from Melbourne University demonstrated how lacking the currently available data is. They found in their second report (Quantifying Phoenix Activity: Incidence, Cost, Enforcement) that there was no data set that could help them measure the frequency and costs of phoenix activity in Australia.[12] Therefore, any report that announces the supposed costs of phoenix activity is based upon a guess (and not one as educated as the Phoenix Research Team). This is not meant to suggest that phoenix activity is not a policy problem to be addressed but it underlines that the top researchers into phoenix activity have no data set to draw upon in their empirical research. Any statement about the "costs" of phoenix activity made to the committee is a guess and probably guided by bias. Recently, the implementation of the director identification number is a good policy response to phoenix activity because it removes the opportunity for a fake or fraudulent director appointment.

44. Today the best information that we currently have available is obtained by self-reporting of liquidators through EXAD reports[13]. But this information is highly limited, and it is insufficient to use as a scorecard for the system. Furthermore, reporting is currently suspended, and we are awaiting ASIC re-establishing these releases.

45. Data limitations mean it is impossible to measure how inefficient, slow and irrational the system truly is. This makes it impossible to evaluate the system in a rigorous manner. Furthermore, there is an information asymmetry where insolvency practitioners themselves have access to extensive internal firm data to inform their decision-making, but directors, regulators and the wider public are left in the dark.

46. This lack of data has allowed some insolvency practitioners and commentators to appeal to the "poorly paid fallacy" – the claim that insolvency practitioners are underpaid because they do a large amount of "unfunded work" in assetless administrations. While it is true that insolvency practitioners don't recover their

[12] Anderson, H, O'Connell, A, Ramsay, I, Welsh, M, and Withers, H. 'Quantifying Phoenix Activity: Incidence, Cost, Enforcement' (October 2015). See https://law.unimelb.edu.au/__data/assets/pdf_file/0004/2255350/Anderson,-Quantifying-Phoenix-Activity_Oct-2015.pdf.

[13] For the last available report, see https://download.asic.gov.au/media/5416956/rep645-published-18-december-2019.pdf .

target hourly rates on all appointments, they nevertheless have highly profitable enterprises. This could be cleared up of course, by the Australian Restructuring Insolvency and Turnaround Association (ARITA) providing to this Inquiry some of the data that its members hold in their practice management systems about profitability. Insolvency accounting firms meticulously measure their staff profitability and keep a careful track of every block of time, phone call, and even, photocopy.

47. So where is there a lack of information? Currently, we lack clear public statistics on:
    - Financial returns to creditors in voluntary liquidation
    - Success rates of Voluntary Administration (past the DOCA stage)
    - Costs to creditors in pursuing action
    - Use of recovered assets by liquidators
    - True rates of phoenix activity
    - Hours of professional labour / Hourly rates applied by insolvency practitioners (on activities such as investigations, reporting, accounting and recoveries).

48. Developing a better measurement of system would likely result in ongoing pressure for reform.

49. So, given the deficiencies in ASIC data, how can we assess the success of current restructuring options in the corporate insolvency system? As to small business restructuring the success rates so far are astounding when compared to Voluntary Administration.[14] My hypothesis is that they are being facilitated by favourable voting by the Australian Taxation Office and these successful restructure results may reduce as the process matures. Consider the data below:

Financial year	Appointments	Plans approved	Plans fulfilled successfully
FY22	70	37	unknown/in progress
FY23	90	66	unknown/in progress

50. This result is astounding because the restructuring plans approved by creditors are 52% in FY22 and 73% so far in FY23. However, it should be noted that this does not calculate the number of successfully completed plans and the overall numbers of SBRP appointments are very low as a percentage of the total number of companies that have gone into external administration. Nevertheless, the statistics so far are very promising and may just make Australian small business restructuring the most successful restructuring model currently being applied around the world.

[14] https://asic.gov.au/regulatory-resources/find-a-document/statistics/insolvency-statistics/insolvency-statistics-current/ Australian Current (as at 9 November 2022) Australian Insolvency Statistics

51. When we move to Voluntary Administration, the available data is far less positive. If we assume that a successful Voluntary Administration is one where the company enters into a deed of company arrangement (DOCA), and then continues to trade in the medium term, things do not look promising:

   - When the Parliamentary Joint Committee on Corporations and Financial Services looked into corporate insolvency in 2004[15] in 'Corporate Insolvency Laws: a Stocktake', ASIC reported that from 1993 and 1997 of the 5760 companies that entered into Voluntary Administration, only 10% resumed "normal trading".

   - In 2015, the Productivity Commission reported that, based on ASIC data, within 5 years of Voluntary Administration, 78 per cent of companies were deregistered.[16]

   - Overall, the contribution of Voluntary Administration to wholly successful restructures may only be 1% of insolvent companies. This 'back of the envelope' calculation from statistics is as follows:

      i. 13% of insolvent companies appoint Voluntary Administration over liquidation[17];
      ii. 29% of Voluntary Administrations entered into a deed of company arrangement (as opposed to going into liquidation)[18]
      iii. My estimate of the percentage of successful deeds of company arrangement is 25% of all DOCAs entered into;
      iv. The multiplier effect is 0.13*0.29*0.25= 0.01

52. Let that sink in — the percentage of insolvent companies that successfully restructure through Voluntary Administration is 1%. It is no surprise, given the poor success rates of this procedure, that lawyers and the wider public see the Voluntary Administration process as a "glorified liquidation", rather than a robust formal process for restructuring. It would be a sensible hypothesis that many of the SMEs that were put into Voluntary Administration should have been put straight into liquidation rather than attempt a restructure that is doomed to fail. To evaluate the merits of this argument, the Inquiry does not have sufficient empirical research and must instead rely on the observations of industry experts.

53. If the Inquiry wants to consider exactly what kind of data it lacks, it should read a 2009 article authored by Elizabeth Warren, current US Senator, former Bankruptcy Professor at Harvard University, and former candidate in the 2020 US Presidential

[15] https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2002-04/ail/index
[16] See https://www.pc.gov.au/inquiries/completed/business/report
[17] 2019 Australian Insolvency Statistics
[18] Presentation delivered by Professor Harris 12 March 2020, Law Society Insolvency Masterclass – preliminary PhD research results.

Primaries: This Inquiry will not find empirical data and theory in Australia of the same quality. The article concludes:

> *Emergency surgery is never pretty and often unsuccessful, but the data reveal that Chapter 11 offered a realistic hope for troubled businesses to turn around their operations and rebuild their financial structures. These data show that prospects are far better than much of the world has been led to believe.*[19]

54. Going back to the 'Objects' of Voluntary Administration, it must be accepted that the goal is not to turnaround a business in every case: A Voluntary Administration might still be considered a success if it results in a better outcome for creditors than what they would receive in a 'straight' voluntary liquidation. There, the results also do not look particularly positive. In a 2014 study of a cross-section of DOCAs by Mark Wellard[20], it was demonstrated that creditors received, on average, 5-8 cents on the dollar. Hardly a King's ransom, or, at least, further evidence that the pursuit of creditor returns in corporate insolvency is a red herring.

55. Summing up its deficiencies, we might say that Voluntary Administration was and is a mechanism far removed from a good theory about small business and entrepreneurship and any supporting economic or financial analysis. It may be that most companies should be wound up rather than restructured, but on the other hand the evidence is that Voluntary Administration is not fit for purpose for SMEs. It may be that the more streamlined small business restructuring procedure is more practical than Voluntary Administration for insolvent SMEs that are feasible to restructure.

Shortcomings of existing EXAD reports and better statistics to gather

56. Given the observed lack of necessary statistics, what are the specific shortcomings in the current statistics and how might they be remedied? Focusing on the EXAD reports:

EXAD reports	More valuable statistics
• Identified causes of failure in EXAD reports are symptomatic thinking (inadequate cash flow, poor strategic management and trading losses etc).	• Better analysis of the *root cause* of failures. • Comparisons between directors' explanation in the Report on Company Activities and Property

[19] Elizabeth Warren & Jay L. Westbrook (2009). "The Success of Chapter 11: A Challenge to the Critics". 107 Mich. L. Rev. 603. https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1349&context=mlr

[20] See Wellard, Mark (2014), 'A sample review of Deeds of Company Arrangement under Part 5.3A of the Corporations Act' [2013 ARITA Terry Taylor Scholarship Report]. ARITA Terry Taylor Scholarship. Australian Restructuring Insolvency and Turnaround Association, Australia. Available at https://eprints.qut.edu.au/74002/

	(ROCAP), and the liquidator's explanation given in their statutory report.
• In last EXAD, possible director misconduct was identified in 6,638 reports— 85% of external administrations. As little action was taken against directors, this is likely to be exaggerated by liquidators.	• Mostly civil breaches where debts in business are up to $250k. • Obtain further detail to assist policy makers about whether the complaints are genuine. There is a lack of enforcement by liquidators and a real issue about the role of government in this space.
• Estimated deficiency only	• The total values of assets recovered for external administrations would facilitate analysis of the efficiency of the system.
• No litigation reports	• Reports regarding litigation ran and the outcome of litigation. A key success measure for the system is the outcomes of litigation.
• No analysis of the quality/efficiency of professional work	• Disclosure of time/billing records for professional work undertaken to creditors. Currently no disclosure is required – only general numbers to aid approvals.
• No general efficiency analysis	• General scorecard about returns to creditors as % of assets recovered and relationship to professional fees could create rules of thumb to help creditors develop understanding about process efficiency.
• No report card on assetless administration monies	• Lodgements to allow assessment of value of assetless administration monies utilized by liquidators – value of assets recovered, and number of prosecutions initiated as best metrics.

Recommendations

57. I recommend:
- **ASIC be directed to provide more detailed information about both individual insolvent administrations and the performance of the system as a whole.**
- **Reform to liquidator reporting, requiring that liquidators provide more detailed breakdowns of their fees and costs to creditors.**

Part C: Does Australia have a co-regulation model for corporate insolvency?

58. Our comments here respond to clauses 5 and 6 of the ToR. It would be fair to say that ASIC has not been particularly pro-active as an insolvency regulator. ASIC statistics show that ASIC rarely acts to regulate the activity of insolvency practitioners. According to the latest ASIC report, only one insolvency practitioner has been suspended in the last year. According to page 40 of the cost recovery guide 21, the regulatory cost of ASIC regulating liquidators was $6.677m. Divided by 652 liquidators, this means $10,240 per liquidator. This is no paltry sum, and may indicate that ASIC intends to be quite active. ASIC also notes its surveillance of high risk liquidators and disciplinary action as priorities. It appears that ASIC has some bark but not a lot of bite. It also appears that ASIC has very low confidence in the insolvency profession.

59. ASIC doesn't work alone, however. A system of 'Co-regulation' occurs in a *de facto* manner in Australia through the committee which decides on registration and discipline being composed of ASIC and ARITA (the Australian Restructuring, Insolvency and Turnaround Association) appointees, alongside ministerial appointees (who are often also longstanding ARITA members). This means that the chief industry and lobbying body for insolvency practitioners is itself directly involved in policing the profession.

60. Australia is not alone in having a co-regulation model. New Zealand introduced a co-regulation model last year. However, there are several differences between that approach and the approach in Australia: The co-regulator in New Zealand, the NZ Institute of Chartered Accountants was explicitly introduced by statutory law reform as a co-regulator. In Australia, no such law reform provides ARITA with equivalent responsibilities. It has been co-regulation by stealth.

61. ARITA is a partisan body, committed to preserving the existing financial interests of insolvency practitioners. By contrast, the NZ Institute of Chartered Accountants is a broader body, seen as an 'honest broker', and not specifically involved in lobbying for the insolvency profession.

62. In 2021 a report, "Review of the Insolvent Trading Safe Harbour Report" (November 2021) was released by the Federal Treasury that is pertinent to this submission. It is pertinent because the report was a statutory review of the insolvent trading safe harbour that included consideration of the professionals who should be allowed to provide corporate restructuring advice ("appropriately qualified entities").

63. In its submissions ARITA strongly advocated that only registered liquidators should be "appropriately qualified entities" that could provide safe harbour restructuring advice: "*ARITA's position is that only registered liquidators have the appropriate skillset to undertake such an analysis*."[22] In my view, this position is without any

[21] Page 40 ASIC cost recovery guide
[22] See https://treasury.gov.au/review/review-of-the-insolvent-trading-safe-harbour. Page 54 of the Final Report.

substance, and is evidence that ARITA is acting as a trade union for its members, rather than making sound policy suggestions.

64. The ARITA position of restricting safe harbour restructuring advice to registered liquidators was rejected by the Government on the Safe Harbour review[23] on the basis that many liquidators don't have pertinent skills and because SMEs don't necessarily need a registered liquidator for their turnaround work. As stated on page 54 of the Final Report:

> *We find the argument for flexibility compelling and are reluctant to endorse a view that requires a specific person to be appointed in all circumstances. As various submissions have noted, the deliberate flexibility contained in section 588GA(2)(d) allows for a nuanced and adaptable application to companies of all shapes and sizes. A general theme running through this report is that SMEs' access of safe harbour is limited in practice, but absent any wholesale reform of insolvency laws that separately addresses SMEs, the provisions should still be capable of application to SME directors. Accordingly, the provisions need to be able to be enlivened by access to circumstance-appropriate advice in the SME market.*

65. Then at page 55 of the Report:

> *First, although we fall short of recommending that a registered liquidator be prescribed to provide the better outcome advice, we do wish to reiterate that in most circumstances a registered liquidator or someone with deep insolvency experience will be the appropriate adviser to provide the liquidation and Voluntary Administration analysis that informs and underpins the better outcome analysis. The unique position that the registered liquidator occupies is having the same lens (based on experience) that another liquidator will have when assessing the liquidation/ administration position in its better outcome analysis, and that a court may place greater weight on that.*

66. The report continues:

> *However, a better outcome analysis also requires an analysis of the 'upside counterfactual'. No doubt, there are some registered liquidators with experience and skills to analyse financial models and forecasts, and to compare and evaluate the administration/liquidation analysis with the 'upside position', but not all have that experience. Further, in many (particularly complex) matters, industry-specific experts will be required to attest to models and forecasts. In addition, ARITA's survey suggests that there are registered liquidators who have not provided safe harbour advice to date and some, for various reasons, who are not likely to engage in performing safe harbour advisory work.*

67. It is clear to me that when you read between the lines, that Report expresses the valid concern that insolvency practitioners both:

[23] As above.

- do not have the economic incentive to undertake safe harbour restructuring work (because external administrations are more profitable), and
- lack the general business skills that are useful in this context (due to their narrow training background).

68. In my view, it is completely unsurprising that insolvency practitioners lack some of the useful skills for restructuring work: The nature of their training is nothing to do with general business skills (i.e., 4000 hours working in an insolvency accounting firm). Furthermore, there is no major financial incentive for the insolvency practitioner to get involved in this kind of work: There is a conflict of interest in an insolvency practitioner procuring restructuring work from directors, and then later investigating them in a formal insolvency appointment. There is also a general lack of financial motivation to help turn around distressed businesses, due to the higher profitability of a more straightforward liquidation (or 'glorified liquidation', in the case of Voluntary Administration).

69. What relevance does this have to an assessment of the current co-regulatory model? In my view, ARITA has demonstrated that its primary interest is in supporting insolvency practitioners, rather than businesses generally or the Australian economy. Furthermore, the insolvency practitioners that ARITA supports do not necessarily have the optimal skillset to support restructuring. Which is a problem, given the importance of restructuring for the system as a whole. This makes it ill-suited as a co-regulator.

70. Overall, it is fair to say that the *de facto* co-regulatory approach isn't working. ASIC is either not funded to, or not interested in, a more robust supervisory role over insolvency practitioners. And ARITA's role lacks the impartiality to perform this kind of public service role. ARITA is a private association with limited objectives and no demonstrated commitment to public service and the promotion of knowledge.

Recommendations

71. I recommend:
    - **Transfer government oversight of SME corporate insolvency to the Australian Financial Security Authority (AFSA).** As they are the body responsible for personal insolvency and bankruptcy, they have the existing institutional knowledge and a good reputation for dealing with insolvency in Australia. While it might be argued that dealing with corporate matters is distinct from dealing with personal business matters, it is worth observing that in Australia there is often little functional difference between sole traders and small companies. ASBFEO statistics show that sole traders make up nearly 63 percent of Australian business, and micro-enterprises with 1-5 employees make up a further 25.7 percent.[24] Consequently, it should be quite straightforward for AFSA to move from personal insolvencies into corporate insolvencies. With the corporate

[24] https://www.asbfeo.gov.au/sites/default/files/2021-11/ASBFEO%20Small%20Business%20Counts%20Dec%202020%20v2_0.pdf

insolvency role, AFSA could focus on practitioner quality, collection of statistics and prosecution of fraud in system.

- **That the Australia Restructuring, Insolvency and Turnaround Association (ARITA) be removed from involvement in registration and disciplinary actions against insolvency practitioners**. ARITA lacks the impartiality to perform this kind of public service role. ARITA is a private association with limited objectives and no demonstrated commitment to public service and the promotion of knowledge.
- **A requirement for general business skills for those seeking registration as an insolvency practitioner**: Requiring insolvency practitioners to have general business skills would assist them with restructuring work and increased professional esteem in the business community.

Part D: How does Voluntary Administration compare to small business restructuring?

72. In part B, I discussed the failings of Voluntary Administration as a form of business restructuring. In most cases, Voluntary Administration for SMEs is nothing more than a "glorified liquidation", with the end result being the destruction of a business.

73. ASIC and insolvency practitioners themselves have repeatedly blamed businesses for the failure of the system (usually asserting that directors have sought help too late for Voluntary Administration to be effective). ASBFEO disagreed with that analysis.[25] So do we. There are various features of Voluntary Administration which work together to make it a generally ineffective form of SME restructuring in Australia.

74. The problem is that, ultimately, Voluntary Administration is not fit for purpose for the SMEs that dominate the Australian economy. As mentioned earlier, SMEs make up a significant chunk of Australian businesses. In fact, small businesses alone (1-20 employees) make up 97 percent of Australian businesses.[26] Understandably, these businesses have a low asset base. Drawing on ASIC statistics, ASBFEO observed that 85% of businesses going into liquidation had assets of less than $100,000 and 37% were reported as assetless. While Voluntary Administrations may commence with a higher amount of assets (as it often precedes voluntary liquidation), they are also likely to be minimal. A low asset base means that any remaining assets of the company are likely to be chewed up in Voluntary Administrator remuneration and costs. Remember — the Voluntary Administrator has priority for payment from company assets over all unsecured creditors.

75. In my experience it is also necessary to observe that, generally, insolvency practitioners have no interest in managing small businesses. Insolvency practitioners sitting in offices in the city do not and cannot be expected to actually manage

[25] The Australian Small Business and Family Enterprise Ombudsman. See https://www.asbfeo.gov.au/policy-advocacy/policy-insights/insolvency-practices-inquiry-2020.
[26] ASBFEO Small Business Counts. December 2020. Available at https://www.asbfeo.gov.au/sites/default/files/2021-11/ASBFEO%20Small%20Business%20Counts%20Dec%202020%20v2_0.pdf.

businesses such as construction and transport companies. A debtor-in-possession procedure is far more practical in a small business scenario where the proprietors of the business continue to invest 'sweat capital' and insolvency practitioners can stick to what they do best – attending long lunches in the city and sending lots of emails.

76. So how much does a Voluntary Administration cost? ASBFEO reports that costs start at $12,000 for the most straightforward procedure[27], with an average cost of around $50,000. My opinion is that a figure of $50,000 is more accurate as a median rather than average cost. Professor Jason Harris's recent doctoral research supports this figure with an estimation, based on interviews with Voluntary Administrators and stakeholders, that a Voluntary Administration costs from $30,000-50,000.[28] It is disappointing that we cannot look to more precise figures for such an important issue.

77. Professor Harris's research does reveal some reasons why Voluntary Administrators may have legitimate reasons to charge significant fees:[29] Trading costs, personal liability, and disputes with creditors can all legitimately rack up the costs. However, in our view, **overcharging is rampant in the industry and there is no legitimate reason for Voluntary Administrations to be generally running up such large bills**. As observed earlier, there are no detailed statistics kept on how and why Voluntary Administrators charge what they do. Nor is this charging effectively policed by anyone. Arguably, this outcome is influenced by ARITA being a co-regulator — it's the inmates running the prison.

78. As creditor approval is required for Voluntary Administrator fees, can't they just refuse to pay? Not really. Voluntary Administrators can appeal to the court, but the court almost always sides with insolvency practitioners. There is also the option to appoint a 'Reviewing Liquidator' to review the proposed charges, but this is itself an expensive procedure for creditors, so is little used thus far.

79. To summarise, Voluntary Administration:
    - Does not usually result in a debt compromise and survival of the underlying business, which is the primary aim of the procedure.
    - Allows expensive Voluntary Administrators to 'clip the ticket' and charge outrageous fees, with no effective checks or balances on what they charge.
    - Ruins business goodwill as a declaration that the business has entered Voluntary Administration translates as a 'failed business' to the general public. The public and the media see Voluntary Administration, Receivership and Liquidation as the same and therefore the stigma of collapse attach to each equally.

80. Admittedly, Voluntary Administration is not all bad: Voluntary Administration appears to work quite well for large corporation restructures (e.g., the relatively

[27] See page 28 of the above ASBFEO report.

[29] (2021) 'Promoting an Optimal Corporate Rescue Culture In Australia: The Role And Efficacy Of The Voluntary Administration Regime'. Adelaide Law School. Available at https://abrt.org.au/wp-content/uploads/2021/09/Jason-Harris-PhD-thesis.pdf, p138.

quick Voluntary Administration sale of Virgin Airline preserved the business and many jobs). It works in those cases because:

a. There is usually a business that is, fundamentally economically viable because it may only need a restructure of its balance sheet. In these cases, insolvency often arises due to large debts and cashflow hits that make it hard to meet debt repayments. With SMEs it is often unclear whether the business is fundamentally viable and worth the expensive restructuring involved in Voluntary Administration.
b. They have a sufficiently large asset base to absorb the costs of Voluntary Administration. As Voluntary Administrators work on an hourly basis, their fees will make up a much larger percentage of the remaining assets of an insolvent SME than a large company. For example, if a SME goes into Voluntary Administration with $50,000 of remaining assets, and the Voluntary Administrator charges $50,000 for their fees and expenses, creditors get very little, even if the company successfully restructures through a DOCA (because of high fees that deplete deed fund contributions). By contrast, a large company that has $5,000,000 in remaining assets, and the same Voluntary Administrator costs, will have significant assets to distribute to creditors even if the restructure fails and the company goes into liquidation.

81. The fact that Voluntary Administration is creditor-supervised, rather than court-supervised, also weighs in its favour. In this respect Voluntary Administration is probably more cost effective than ‘Chapter 11’ restructuring in the US. Although once again, given the size of large corporates in the US and Australia these conglomerates may be able to absorb high professional fees if overall economic value is delivered by a restructure.

82. For SMEs, small business restructuring has been an excellent development. It means:
    - A streamlined, faster, restructuring process. This increases the chances that the business can reach a debt compromise and return to regular trading before its assets are exhausted.
    - Directors remain in control of their business throughout restructuring. In this way, the business doesn’t lose the ‘goodwill’ and existing reputation by handing over the reins to a Voluntary Administrator who ceases to trade. It recognizes that no SME is viable without the continued ‘sweat capital’ of its proprietors.
    - Creditors still have the opportunity to reject the proposal if they choose to participate in the voting process. But the nature of the procedure encourages sensible commercial behaviour by all stakeholders.

Recommendations

83. I recommend that the existing SBRP reforms be extended and improved upon, and that:

- **The current SBRP upper limit be lifted from $1 million in debt to $5 million**. This would mean that all small-to-medium-sized businesses which currently go into external administration[30] would be able to utilise the procedure, and leave Voluntary Administration just for that small proportion of very large corporates who can afford it and could benefit from it.
- **For Voluntary Administration itself, the process should be streamlined further**. For example, recent reforms have streamlined the voluntary liquidation process allowing liquidations to occur without meetings, and with simplified reporting requirements. A similar approach could be applied to Voluntary Administration which currently requires two meetings and has heavy reporting requirements.
- **There be increased transparency and reporting around the costs of Voluntary Administration**. A breakdown of costs for all Voluntary Administrations should be public information. This would include disclosure of time cards for insolvency practitioners and litigation costs.

Part E: What is and should be the role of insolvency practitioners?

84. Insolvency practitioners in liquidation and Voluntary Administration have a complex set of responsibilities:
    - They have a *business management role*, as they take control of the company from directors and oversee its continued trading.
    - They have an *advisory role* where they can advise businesses in difficulty of the options they have available (though note below, the difficulties this can mean when trying to uphold the independence requirement)
    - They have a *bookkeeping role*, in making sense of the company's financial records, and seeking to establish precisely the assets and liabilities of the business
    - They have an *investigative role*, inquiring into potential director wrongdoing and reporting on it
    - They have a *litigant role*, where bringing legal action against directors or creditors for inappropriate antecedent transactions
    - They have an *adjudicative role*, in making key decisions relating to the external administration, such as advising that debt compromise ('DOCA') be agreed to
    - They have an *administrative role*, in seeing that the process is conducted in an orderly manner, and where appointed as a deed administrator, that the creditors get their entitlements.

85. The complexity of the role, with often conflicting duties, means that in some sense it is incorrect to see insolvency practice as a *profession* at all. There is no coherent 'core' of activities as there is in professions like accountancy, law, or medicine. And this means it is difficult to apply a stringent code of professional conduct/ethics to the position — something long considered a hallmark of a profession. It is also clear that insolvency practitioners lack the key ingredient of a profession – that they

[30] https://download.asic.gov.au/media/5416956/rep645-published-18-december-2019.pdf, p42.

exercise their skill primarily in the interests of others.[31] For instance, we do not assert that stock brokers or real estate agents are a profession.

86. Even though insolvency practitioners have a duty under the law to act with independence[32], and work towards a fair distribution for creditors, this directly conflicts with the fact that they are chosen and appointed by directors (in the case of Voluntary Administration) or directors and shareholders (in the case of a voluntary liquidation). This system is poorly thought out and the insolvency practitioners find themselves under pressure to compromise their integrity in order to attract business.

87. Aside from the theoretical considerations which mean that insolvency is not a true profession. What about the actual behaviour of insolvency practitioners? Recent empirical/phenomenological research from academic Dr Elizabeth Streten[33] reveals some disappointing perspectives from insolvency practitioners. There, detailed interviews with insolvency professionals demonstrate, in our view:
    - A lack of maturity and general 'whininess'. For example, one practitioner laments "I dislike when there's a bias judgment against my values and intentions … I get that a fair bit where a person with the wrong end of the stick will question my morals, my intentions, accusations of being conflicted or having a particular outcome planned when that's certainly not the case"
    - An expectation of a high income, while contributing little to the wider economy.[34]

88. These elements, put together, suggest to us that insolvency practitioners are not fit to 'self-regulate' by having a regulatory role for their own profession.

89. By contrast, the *role of Restructuring Practitioners* is more coherent and better delineated within the Corporations Act 2001 (Cth). With respect to the responsibilities themselves, the Restructuring Practitioner reforms get it exactly right: Restructuring practitioners are monitors, not business operators. The directors retain day-to-day management control and can continue trading during the process, while the Restructuring Practitioner focuses on providing advice and checking finances. Restructuring practitioners are not trading or investigating wrongdoing in a

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[31] Definition of 'Profession' by the Australian Council of Professionals, see https://www.professions.org.au/what-is-a-professional/.

[32] See https://asic.gov.au/regulatory-resources/insolvency/insolvency-for-creditors/independence-of-external-administrators-a-guide-for-creditors/.

[33] (2019) *Practitioners' perspectives: Experiences adhering to legal and ethical regulatory standards*. PhD thesis, Queensland University of Technology. Available at https://eprints.qut.edu.au/134254/.

[34] See also in the 2010 Senate Inquiry, The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework, one submitter, barrister Geoffrey Slater observing:

> *"for some of the larger firms in Australia we are talking well over $4 million, or $5 million or $6 million per year for the partners of the insolvency. That is more than any of the partners make at the big firms such as Allens Arthur Robinson or Clayton Utz or anywhere like that."*

detailed way as Voluntary Administrators are but they are required to terminate the process if there is something fundamentally wrong. It is also a sensible demarcation that Restructuring Practitioners appointed to a company should not become liquidators afterwards.

Should restructuring be a monopoly for registered liquidators?

90. There is one potential problem with the existing small business restructuring model, which is the required qualifications/eligibility criteria for the purposes of registration.

91. Australia has a two-tiered system of corporate insolvency practitioners:[35]

    a. Those who have been registered to practise as an "external administrator of companies, a receiver and receiver and manager, or only as a receiver and receiver and manager "
    b. Those who have been registered to practise only as a "only as a Restructuring Practitioner for a company or for a restructuring plan".

92. The eligibility requirements for each type of practitioner are different, with the distinct additional requirement that Restructuring Practitioners be "recognised accountants", meaning a member of one of three professional accounting bodies in Australia.

93. Is it appropriate that the insolvency profession is so thoroughly dominated by accountants and in particular, accountants who have spent their entire career in insolvency accounting firms? Australia is somewhat of an anomaly in this regard because it has deliberately narrowed the 'profession'.

    - In the US, lawyers generally have oversight of restructuring proceedings (Chapter 11 Bankruptcy), with accountants playing an analytical role.
    - In the UK, qualification for the role is competency-based with a rigorous testing system.
    - New Zealand, which has recently instituted a more rigorous regulatory framework for the insolvency profession, also does not require that insolvency practitioners be professional accountants.[36]
    - Germany, which has also recently updated its framework for regulation of the profession, also has a more liberal interpretation for who can operate as a Restructuring Practitioner: Experienced tax advisors, certified public accountants, lawyers, and other qualified persons are eligible.[37]

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[35] https://asic.gov.au/for-finance-professionals/registered-liquidators/applying-for-and-managing-your-liquidator-registration/
[36] https://www.companiesoffice.govt.nz/all-registers/insolvency-practitioners/licensing/.
[37] https://www.schultze-braun.de/fileadmin/de/Fachbuecher/Insolvenzjahrbuecher/Insolvenzjahrbuch2022/Yearbook_2022_The_Restructuring_Practitioner.pdf?_=1644239119.

94. While accounting is no doubt an important skill for insolvency and restructuring Practitioners, it is by no means the only skill required, so it is not clear why this has been made a hard requirement in Australia. There is also a lack of recognition of general business skills and knowledge in the Restructuring Practitioner registration requirements. Given that the role involves little investigation, general business skills are arguably the most important skills for the role. It may be that one factor behind the lack of success of restructuring in Australia is the lack of general business skills of insolvency practitioners: They are trained in accounting workhouses in the cities and spend their days largely behind the desk. Although it does not appear to have been studied, it may be expected that a more entrepreneurial Restructuring Practitioner would have greater success. It is fairly intuitive that broad business skills in the areas of marketing, management, finance and economics would be more useful in a turnaround job.

Recommendations

95. I recommend the corporate insolvency law framework:
    - **Recognise that insolvency practice does not meet the expected norms of a profession, and therefore insolvency practitioners should not be (largely) self-regulating**
    - **Recognise that liquidators and Restructuring Practitioners should have different skill sets**, and that Restructuring Practitioners should have general business skills to support their objective of helping small business to turnaround (rather than undertake investigations and (potentially) legal actions in the case of liquidations)
    - **Open the criteria for insolvency practice in general to enable and encourage non-accountants to enter the field**, **and especially to become Restructuring Practitioners**. This would bring Australia further into line with overseas jurisdictions
    - **Clearly separate restructuring and liquidation roles**. To avoid conflicts of interest, the same insolvency practitioner should not be allowed to act as Voluntary Administrator or Small Business Restructuring Practitioner and then become a liquidator of the same company. This would separate the role of corporate doctor and corporate policeman for insolvent companies.

Part F: Who should give advice before appointment?

96. When a company is in financial difficulty, who should directors turn to for advice on next steps? Their tax accountant is unlikely to have a deep knowledge of insolvency matters as with generalist solicitors. Insolvency practitioners are reluctant to give advice as the ‘independence’ requirement for practitioners means that they cannot subsequently accept a formal appointment in a liquidation or Voluntary Administration. The lack of alternatives means that dodgy phoenix operators have stepped into fill the void between the small practice accountant and an insolvency practitioner.

97. It is well-known in the industry that small practice accountants regularly consult insolvency practitioners that they have relationships with to seek advice about their financially distressed clients. None of this advice is documented, or likely to be suitable for the circumstances of the financially distressed business because it is too general. The problem with undocumented advice is that it cannot be reviewed or audited. The problem for policy-makers is that this is likely to be shallow advice while the insolvency practitioners keep their 'fingers crossed for a Voluntary Administration'. There is no recognised turnaround profession in Australia that can provide sensible advice to financially distressed businesses in the 'Zombie zone' before they hit actual insolvency (where a debt restructure is required for survival). Recently, the Association for Business Restructuring and Turnaround (ABRT) has been created to fill this void and this association should be supported.

98. What practical steps might be taken to improve this situation? In my view, the 'independence' requirement for insolvency practitioners needs to be loosened up/re-imagined for restructuring appointments. For example, in the United Kingdom, insolvency practitioners are allowed to advise on pre-packaged insolvency arrangements prior to appointment.

99. The separation of appointments between restructuring and liquidations should mean that Restructuring Practitioners can give substantive pre-appointment advice. The problem is that in the current system of Voluntary Administration the same appointee is expected both to help the directors develop a restructure plan and trade the business, and then also investigate (and potentially take action against) those same directors if the restructure fails and the company is liquidated. This creates a conflict of interest and also is a perverse financial incentive for the Voluntary Administration to fail so that the appointee can collect fees for both a restructure and liquidation process. This situation cannot be permitted to continue.

Recommendations

100. I recommend that the corporate insolvency system be reformed to:
- **Empower insolvency practitioners to advise on insolvency matters before appointment, but require that advice to be put into writing as a condition of appointment**. It is unrealistic to expect that no pre-appointment advice will be given and putting it in writing is good protection that appropriately balanced advice has been given.
- **Encourage the development of a turnaround profession (as distinct from registered liquidators)** who have the skills to assist a financially distressed business before it is actually insolvent.

Part G: How should insolvency practice and restructuring be priced?

101. Insolvency practitioners are not restricted to charging in any particular way, and can choose to charge:
    - On an hourly basis

- By a quoted fixed fee (based on an estimate)
- As a percentage or realized assets
- On a contingency basis, depending on the outcome achieved.

102. The reality is, however, hourly fees are chosen in the vast majority of appointments, particularly in Voluntary Administration and liquidation. The other options are only implemented when there is a savvy secured creditor appointment (such as a bank appointing a receiver).

103. In my view, hourly charging only supports the incompetent and unethical. Insolvency practitioners are incentivised to spend as much time as possible on administrative tasks (that can be readily delegated), rather than to achieve efficient or desirable outcomes. It also means that there is no incentive to trade-on for insolvency practitioners: As a Voluntary Administrator becomes personally responsible for any debts entered into by the business, and they are paid the same hourly rate no matter what they are doing, they spend their time poring over the books, rather than running the business. This has the effect of running down the goodwill of any business that enters Voluntary Administration.

104. By contrast, the new small business restructuring process is a fixed fee that is agreed upon by the directors at the date of appointment. This is a more appropriate fee structure for restructuring particularly given the short time frames of Voluntary Administration and small business restructuring.

105. Even if there is no malice involved, overcharging results simply from the way corporate insolvencies are funded. This applies to Voluntary Administration, liquidation and receiverships. As many corporate insolvencies involve businesses with few assets, insolvency practitioners are incentivised to cross-subsidise assetless administrations through charging more than necessary on external administrations with assets.

106. As was done with financial planners, we need a significant rethink of the basis for remuneration. The excessive fees of insolvency practitioners have long been observed, but attempts to rein in those fees have been ineffectual:
   - Creditors can seek court action to challenge remuneration. But they must fund this themselves and the difficulty in proving that a fee is unreasonable means Judges will rarely side against liquidators.
   - The reviewing liquidator mechanism is rarely used.

107. Overcharging is an instance of market failure that should either be solved through government intervention or the simplification of charging models. This could involve:
   - Proper government support for assetless administrations (as occurs through AFSA in the case of personal insolvency)
   - More robust complaint procedures managed by ASIC or another competent body to ensure that insolvency practitioners do not overcharge.

- Regulators setting 'rules of thumb' as guidance for the percentage of total assets that insolvency practitioners should be able to charge in external administrations as fixed fees.

Recommendations

108. I recommend:

- **Pricing structures be regulated to move to a 'percentage of assets' model**. This would encourage commerciality and better planning by liquidators.
- **Revamping the complaints process** so that ASIC or another designated regulator takes action against overcharging liquidators.
- **Considering a proper funding model for assetless administration** to avoid cross-subsidy.