Insolvency Law
Bulletin

Rebuilding the structure of the Australian insolvency system

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As many have commented, including ourselves, it has been well over 30 years since the last major inquiry into insolvency law in Australia, resulting in the Harmer Report of 1988.[1] That has led to calls for a further inquiry, in particular in light of what is a different commercial and social world, in another century.[2]

It is important that any such review not be too narrow in scope, to focus solely on improving the existing law. The review needs to evaluate the system or structure within which the existing insolvency law operates, and its resourcing and funding, in order to ensure that there are sufficient means to apply whatever law reform recommendations are made. That is where we suggest that the current structure, most of which dates back to the 19th century (and some of which goes back all the way to the 1500s), is deficient. It is argued that the current system involves market failure and requires a greater role for government — the state — for the system to operate efficiently and effectively. We suggest a government Official Receiver role, but newly designed to meet the needs of a reformed insolvency law system.

The focus on resourcing is important because an insolvency regime presents particular practical and commercial issues that need to be acknowledged and addressed in any law reform. The nature of the public and private interests served by insolvency is an overarching issue, and who is to be responsible for those, respectively. Insolvency inherently involves limited funds, which although limited, are intended to be available for the creditors, but only after the costs of the administration of the insolvency are paid. Those costs must bear not only the work done in attending to the private interests of creditors but also the public interest demands of insolvency, in particular of investigating misconduct and maintaining the integrity of the system.

There is not enough money to go around

In that regard, what statistics are available reveal that there is not enough money remaining in insolvent estates to properly fund the costs of administrations, let alone pay dividends to creditors.[3]

An Official Receiver role across both corporate and personal insolvency would address what we say is a market failure with the current system. Among other concerns, that role would address another issue, the high cost of access to the insolvency system for debtors and creditors in corporate insolvency.

Allocating responsibility fairly between public and private interests

It is initially important to acknowledge that insolvency needs to deal with both public and private interests. The nature of those interests and who attends to them and who should bear responsibility for them must first be examined and balanced appropriately. The approach to clarifying those respective responsibilities in insolvency has been explained as being that "private functions should be performed by the private sector and paid out of funds otherwise available for distribution among creditors, while public functions should be performed by public officials and paid for out of public funds . . .".[4]

To a large extent that is a useful division subject to the various overlaps of functions that inherently exist; for example, while investigation of misconduct may be seen as a public role, it may well also serve to recoup money for creditors. However, that overlap can also exist by default, because the separation between public and private functions has not been understood and applied in past law reform.

The need for public funding of various public functions of insolvency is relatively uncontentious in relation to the system of courts, a public register, and relevant laws.[5]

Beyond that, the problem is not that there are insufficient resources to administer the system, with both an experienced private insolvency profession in Australia and a government staff with varied experience in insolvency matters. It is the allocation and delineation of responsibilities within that system that we suggest need rethinking and readjustment.

An initial law reform inquiry

To begin the process of law reform it is important to assess what work is actually needed in insolvency matters in terms of principle rather than what work is

required to be done as the present law requires. Some tasks the law requires may no longer be necessary — we query, as we explain, the high level of attention the law requires to be given to informing creditors; other tasks may be needed — greater attention to and access for assetless businesses.

In parallel with that process there is a need to consider how or whether there is a structure within which those tasks can be resourced and executed. The traditional approach of examining the regime as a series of component parts — winding up, voidable transactions, examinations, discharge etc — can be best assessed only once a viable structure is built that is adequate to support the interests of the various parties, and the community, using it or seeking access to it.

Initial data

As many inquiries have said before,[6] Australia lacks good quality data on the operation of Australia's insolvency system, which is all the more unsatisfactory given the quantitative nature of much of the data needed. What limited data we ourselves have extracted gives us cause for concern, suggesting, as we have said, that funds are limited, that many public interest tasks are performed by the profession and charged to creditors, and that the access to the system is limited.

For example:

- A 2013 study showed that liquidators conducted unfunded work in external administrations to the value of over $48m annually.[7]
- 92% of external administrations pay no dividend returns to creditors.[8]
- A high proportion pay no remuneration to the liquidator at all[9]
- Around 58% of companies that enter liquidation have less than. $10,000 in assets, and 37% of companies have no assets.[10]
- A study of reports to creditors in voluntary administration revealed a mean dividend estimate of just 5.5c in the dollar.[11]
- A 2020 AFSA report showed that 31% of bankrupt estates handled by private trustees paid no remuneration.[12]
- Dividend returns to creditors in bankruptcy are in the order of 1.6 cents.[13]
- Five or more times as many companies are deregistered by default, through s 601AB of the Corporations Act, as are deregistered following an external administration.[14]
- Liquidators refer over 4,000 statutory breach reports to ASIC each year, and trustees in bankruptcy refer a similar proportion.[15]

Drawing on these figures, it is apparent that much of the work in insolvency is performed by the private profession to the extent that is commercially feasible, which involves accepting a certain proportion of risk-based non-paying estates. While there is little other information on that deficiency, it seems to be inherent, with a 1979 inquiry finding that 70% of court ordered liquidations were "unremunerative" or assetless.[16]

This suggests that, on a commercial basis, practitioners' unpaid costs are recouped from other high value estates — through cross-subsidisation,[17] otherwise known as "swings and roundabouts"[18] — which was said to be the system that supported the long-established official liquidator role.

It was through concern about decades of cross-subsidisation that the government in 2017 abolished the role of official liquidator, on the basis that liquidators should not have to do unfunded matters. Creditors would need to fund liquidations, although it was accepted that this may result in more assetless companies by-passing the system.[19] Whether that outcome has occurred is yet to be analysed.

That did not expressly address voluntary liquidations, which Treasury raised in later proposals in the context of proposed reforms to deal with unlawful phoenix activity. Its two proposals were:

i. to provide access to government funded liquidators on a cab rank system for voluntary liquidations of low or no-asset companies to "replace the current widespread practice of directors indemnifying registered liquidators for their costs";
ii. to establish a government liquidator to conduct a streamlined external administration of SMEs with the option of appointing a private registered liquidator if circumstances warranted it.

Neither proposal proceeded further with the matters left to the market.[20]

The apparent outcome is well explained by Professor Helen Anderson, referring to losses to creditors from abandoned companies, being those where the directors have not initiated any form of external administration, that ". . . both employees and general unsecured creditors . . . are in a difficult position. They will need to fund the company's liquidation themselves if they hope to recover anything of what they are owed, and risk further losses if it eventuates that company has no assets. As a result, many of these creditors do nothing, and the abandoned companies are eventually deregistered by ASIC for failure to return documents or pay annual fees".[21]

A director of a company that is insolvent may literally just abandon the company and start again in a new company. There are risks in doing so, in particular where

there are unpaid tax liabilities.[22] Anderson found that five times as many companies are deregistered by this default process as those which proceed through an external administration. The suggestion is that they are insolvent entities that can't be wound up because they have no funds to do so, or because their directors do not want the scrutiny of their possible phoenix use of the company.[23]

That data is disconnected between corporate and personal insolvency, for example as to the extent of directors' personal insolvency arising from corporate failure. That would most likely show that the corporate vs non-corporate distinction in assets and liabilities is often blurred for small firms, through personal guarantees and other such liabilities, to the extent that it has been said that it is personal insolvency regimes that are often the more relevant for small businesses.[24] AFSA now usefully gives some data about what it terms business bankruptcies.

Initial law reform ideas

The limited data referred to on which we rely is relatively accessible on public databases. While there is much more that could be obtained, we draw some basic law reform conclusions from that data, indicating where structural reform seems to be needed, and a government role, some of which are these.

Too much attention given to unsecured creditors?

First, we query the attention given by the law to unsecured creditors in insolvencies, in particular since the Insolvency Law Reform Act 2016 which set up additional reporting, inquiry and authorising roles for creditors. As the basic figures show, unsecured creditors rarely benefit financially in any insolvencies. While insolvency serves creditors' purposes more than by way of any dividend return, we say that too much time and effort is required to be done by the practitioner notionally on their behalf. Not only is that inefficient, but it leads to an expectation gap that can produce negative consequences.[25]

To some extent, developing information technology (IT) mechanisms and government portals should replace the report-based approach of informing creditors, and mitigate the costs involved,[26] although that is as yet some time away.

Offence reporting over-emphasised?

Second, a significant number of offence investigations and reports are conducted by liquidators and trustees, and, as we have said, funded from moneys otherwise available for creditors. What might have been a general concern about abuse of limited liability in times past may not apply today, or at least should be reassessed, including in light of other better detection and enforcement mechanisms.[27]

In any event, this is a public interest task, that should be publicly resourced. Subject to any law reform finding, that may properly lead to a more refined and more co-ordinated risk-based approach to be taken, again, using artificial intelligence (AI) and IT resources.

Administration or oversight of assetless insolvent companies?

Third, the large number of companies that are simply deregistered by default of compliance with the law brings into focus the question whether all companies, including ones that are insolvent, should be formally wound up or overseen to some extent, or whether that process can be left to the creditors and the debtor, as at present. We ourselves do not see the need for an insolvent company to necessarily be wound up, if some lesser process is suitable.[28]

We acknowledge that over decades and in practice many companies with no or low assets are nevertheless accepted for winding up by the private sector. But the extent to which companies were not wound up because of costs can't really be known though the large number of companies being deregistered by default was identified as a concern back in at least 1995. The then ASC's research paper into phoenix activities and insolvent trading reported that around 92% of Phoenix companies were deregistered by default.[29]

This needs attention, if only initially to oversight and gather data on what comprises these large numbers of deregistered companies, an early task for the Official Receiver.

National interest insolvencies

As a further example, while we have examined whether an Official Receiver is needed for what might be seen as national or public interest insolvencies, we leave open the option of this being developed. As a precedent, in the UK, the Official Receiver is the liquidator of British Steel,[30] with its extreme environmental and health risks; of Thomas Cook, the failure of which called for the largest peace time repatriation of British citizens; of Carillion Constructions, which had extensive government contracts for the construction of schools and hospitals; and most recently a failed electricity supply company on whose electricity supplies local authorities depended.[31] In each case, the Official Receiver was appointed by the court with large private firms appointed as special managers to handle the work under the supervision of the Official Receiver. That default option is not available in Australia.

A new official receiver role

While there is more data to be extracted and explained, we say that on financial and policy bases the role of government must be extended beyond providing the court and register infrastructure. An official receiver in corporate insolvency is required, as there is in comparable jurisdictions — the UK, New Zealand and Singapore — but with an extended role.

Policy debates at the end of the 19th century in England resolved the proper role of the state, following unsatisfactory periods when the law put creditors in control. Official Receiver roles were created in both personal and corporate insolvency.[32] New Zealand went through a similar process of deciding upon the need for such a role with its Official Assignee,[33] as did Singapore in more recent times.[34]

At federation, in 1901, Australia did not appear to reject such a role as to find that the new federal structure and its perceived constitutional limitations prevented a national corporations law.[35] Australia readily adopted the need for an Official Trustee role in personal insolvency. Australian states instead relied upon the "official liquidator" role in their different corporate law statutes or over a century, providing in effect pro bono services to the courts. This continued under federal corporations law before the government accepted, in 2016, that it no longer remained appropriate.[36] Nothing was offered to replace it beyond the continued laissez-faire reliance on the market.

While those overseas jurisdictions offer useful models, we see the role as more expansive than, as in the UK, confined to court appointed liquidations. At the same time, we would not go so far as New Zealand in having bankruptcies administered only by a government Official Assignee.[37] Singapore's structure, which is the result of a relatively recent review which considered Australian law, among others, is also instructive.

An important feature of the model we suggest for Australia is that the official receiver should have authority over the insolvency system as a whole, with a view to removing much of the duplication and inconsistencies that exist between the separate personal and corporate insolvency systems in Australia. Also, with greater recognition is being given to the intermingled nature of small business personal and corporate debt, and the need for insolvency law to provide coordinated holistic solutions,[38] the official receiver could play a role in the development of insolvency law to address such cases. Certainly, better processes for dealing with the insolvency of small business would be a significant issue for any law reform inquiry.

The official receiver, or whatever appropriate name it might be given, would have a number of diverse functions of the nature of those within AFSA — an administration role, registration and oversight, investigation and regulation, and data collection and analysis. Such an agency would:

- enable a complete collection and oversight of all insolvencies;
- provide a filtering or triage process to give attention to those estates requiring attention and those that, on a risk analysis basis, do not;
- more clearly delineate the role of the state and the role of the private profession and the consequent charging of remuneration;
- allow for better regulation of IPs and the system itself, through the provision of appropriate rules, guidelines and also in a more direct manner, by supporting the various tasks and responsibilities of insolvency practitioners that are conducted in the public interest;
- allow more comprehensive data to be collected in order to better assist the law reform process.

No doubt other relevant tasks could be assigned.

An official receiver or a public fund

We acknowledge a threshold issue raised by the Harmer Report and others against the creation of a public office to deal with assetless insolvent companies. Harmer recommended an assetless companies fund be created which would address the costs involved for both the petitioning creditor and the liquidator on the winding up of a company.[39] In principle, we would ourselves be recommending that any public office created would be funded in some similar way to that suggested by the Harmer Report.[40] It may well be that an official receiver role would in fact enlist the private profession. But even under the Harmer proposal, there is the need for a public office to administer the public fund — to set priorities, gather data, and pursue misconduct.

Public v private — capability

We have noted an initial industry response that the private profession is more capable than the public sector in conducting insolvencies and should be funded to do so. In essence, the questions we raise are not so much about capability, as about appropriate allocation of public tasks and their funding. Nevertheless, as to capability, we do not accept or we reject unsubstantiated views about the relative merits of the private and the public sectors. Government is not inherently incapable of performing some of the tasks currently untaken by the private profession, nor is the private sector inherently incapable of performing public tasks. Cooperation and partnerships between the public and private sectors are

also possible to help fund and perform the necessary work. Much also depends on the nature of the public and private tasks allocated.[41]

The reality of any change

Any law reform should acknowledge the expectation gap in insolvency, confirmed as it may be by the data collection exercise we suggest. Importantly, any proposed law reform should not reinforce that gap, rather, the limits of what insolvency can achieve in financial terms need to be explained, and costs and benefits assessed.

We ourselves do not necessarily say that any greater role of the state would lead to, for example, greater return to creditors. The reasons for the limited outcomes for unsecured creditors may be based on other changes in the economy and in society — for example, the move from "bricks and mortar" to intangibles in business.

Rather, our aim is to readjust and reallocate tasks and responsibilities. The present system does not sufficiently delineate the public and private purposes of insolvency such that the work involved, and whose responsibility they are, is unclear, and the costs allocation is opaque. One aim is to at least reveal and clarify the true position.

Law reform data

We have emphasised the need for current and comprehensive data both in relation to the structure and in relation to the utility of many of the recovery and investigative processes upon which insolvency law relies. Unfortunately, the 2010 recommendation for a body to gather and analyse insolvency data was never adopted[42] although there is potential for the new Australian Business Register to assist, and the Small Business and Family Enterprise Ombudsman.

While much data lies with government, more again lies with the private sector itself in the actual files of matters administered. Extraction and publication of that data would much assist any insolvency law reform process. We also consider that a broader input from other disciplines beyond law is needed, information technology, economics and the social sciences being some.

In the meantime, we are continuing to examine and produce ideas for what we say is a need for rethinking Australian insolvency law to ensure it is accessible and efficient and resourced appropriately.

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Footnotes

1. General Insolvency Inquiry, ALRC 45.
2. *The Changing Face of Law Reform in Australia: Commentary on the ALRC's Inquiry into Insolvency, its contribution to the current legal framework and the need for a new review given the passage of over 30 Years,* Justice Sarah Derrington: www.alrc.gov.au
3. See ASIC, Insolvency Statistics Series 3.3 — External administrators' reports time series for 1 July 2004–30 June 2017, December 2017.
4. P Heath, *Insolvency Law Reform: The Role of the State* (1999) NZLRev 569 ["Heath, the Role of the State"].
5. Heath, The Role of the State.
6. Submission to the National Data Commissioner of the writers and others of October 2019: see 27.pdf (datacommissioner.gov.au)
7. *An analysis of official liquidations in Australia*, A Phillips, February 2013; referred to in the Explanatory Memorandum to the Insolvency Law Reform Bill 2015 [Ex Memo ILRB] at [9.135].
8. *Corporate Insolvency by the Numbers*, J Harris, 27 February 2018 — www.australianinsolvencylaw.com
9. *Corporate Insolvency by the Numbers*, J Harris, 27 February 2018 — www.australianinsolvencylaw.com
10. ASIC, *Insolvency Statistics: Series 3, Initial External Administrators' Reports*, Series 3.3, 2019. This report has since been discontinued.
11. Mark Wellard, 'A review of deeds of company arrangement' (2014) 26(2) A Insol J 12.
12. *Remuneration in the personal insolvency system*, 4 March 2020 www.afsa.gov.au
13. AFSA Annual Administration Statistics, 2020–2021.
14. *Insolvency — it's all about the money* (2018) 46(2) Federal Law Review 287–312, H Anderson ["Anderson, It's all about the money"].
15. ASIC Annual Report 2020–2021, *table 6.2.4*. AFSA Enforcement statistics July 2021 to March 2022.
16. *Brian Cassidy Electrical Industries Pty Limited (in prov liq) v Attalex Pty Limited (No 2)* (1984) 2 ACLC 752, referring to the 1979 'Helsham Report'.
17. Ex Memo IRLB at [9.52]–[9.53].
18. Explained in *Re Greater West Insurance Brokers Pty Limited* [2001] NSWSC 825
19. Ex Memo ILRB at [9.137].

20. *Combatting Illegal Phoenixing*, Treasury, September 2017
21. Anderson, *It's all about the money.*
22. See also RI Barrett, *The Plight of a Creditor of a Deregistered Company* (2022) 39 C&SLJ 73.
23. *The Protection of Employee Entitlements in Insolvency*, H Anderson, Melbourne University Press, 2014, at p 94.
24. *Design of insolvency regimes across countries*, OECD CO/WKP(2018)52, M Adalet McGowan, D Andrews, 6 September 2018
25. Mind the Insolvency Gap: Lessons to be Learned from Audit Expectations Gap Theory *(2014) 22 Insolv LJ 178, C Anderson and C Brown.*
26. *The impact of artificial intelligence on the insolvency profession* (2017) INSLB, J Dickfos, C Brown and L Smith.
27. *Offence reporting by insolvency practitioners* (2019) 20(4&5) INSLB 88, M Murray.
28. The need to address insolvent assetless companies is supported by UNCITRAL's Legislative Guide on Insolvency Law, both to support directors and to counter abuse of the system.
29. Treasury, *Modernising Business Registers*, Submission by Melbourne Law School and Monash Business School, 23 August 2017.
30. See *British Steel — is it a wind up?* Corporate Rescue and Insolvency August 2019, A Keay and P Walton.
31. *Counsel General for Wales v Allen* [2022] EWHC 647 (Ch) (21 March 2022)
32. See P Walton, "It's Officialism — the Uncertain Past, Present and Future of the Insolvency Practitioner Profession in the United Kingdom", Gore Browne Special Release SR97, March 2017.
33. Heath, The Role of the State.
34. Report of the Insolvency Law Review Committee, Singapore; see pp 68ff '(B) The Official Receiver as Liquidator of Last Resort'.
35. Explained in *Towards Harmonised Company Legislation — Are We There Yet?* (2012) 40 Fed L Rev 141, RI Barrett; also *Officially Receiving — a history of Australia's bankruptcy law and administration*, C Meiklejohn, ITSA 2010.
36. Ex Memo ILRA at [9.28]–[9.29].
37. New Zealand Law Commission, Study Paper 11, *Insolvency Law Reform: promoting trust and confidence*; *Latest decisions on Insolvency Law Review*, Laila Harré, 28 February 2002.
38. See World Bank's Principles for Effective Insolvency and Creditor/Debtor Regimes, revised 2021; UNCITRAL Legislative Recommendations on Insolvency of Micro- and Small Enterprises (2021). See also A Gurrea-Martinez, "Implementing an Insolvency Framework for Micro and Small Firms" (2021) 30 *International Insolvency Review* 46–66.
39. ALRC 45 Ch 8.
40. We don't at this stage discuss other funding models, such as a charge on assets realised.
41. As to abandoned companies, Anderson has said that it is difficult to see how a government funded pool of private-practice liquidators would deal with them, rather a government role is required: Anderson, *It's all about the money.*
42. Senate Committee Report, *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework,* September 2010, recommendation 1.