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Melinda Cilento, Commissioner
Productivity Commission
Level 12, 530 Collins Street
Melbourne VIC 3000

Dear Melinda

By Post and Email

McGrathNicol submission to the Productivity Commission in relation to its enquiry into Barriers to Business Set-up, Transfer and Closure

At the invitation of the Productivity Commission ("the PC") I participated with you in the Insolvency Roundtable in Sydney on 9 February 2015 on behalf of McGrathNicol. McGrathNicol is an Australasian market leader specialising in corporate restructuring and insolvency.

McGrathNicol partners have led many significant Australasian insolvency and or restructuring projects including Babcock & Brown, Centro, ABC Learning, ION, Great Southern, HIH, Commander Communications, Cubbie Station and Hastie Group to name just a few. In addition, the list of confidential restructuring projects we have undertaken is extensive and covers businesses of all shapes and sizes, from small private companies to listed multinational entities, across all key industry sectors.

My concluded view is that the Roundtable:

1. had appropriate representation from a broad range of stakeholders who are frequently affected by the insolvency process and its outcomes and implications;
2. included a wide range of discussion topics; and
3. provided an excellent forum for the exchange of views between panel members.

Naturally, discussion points tended to align with particular areas of concern of key interest groups and/or the personal ambitions for the industry of the respective participants. I believe that some of the ideas had significant merit, others less so.

What precisely is the problem? From whose perspective?

At McGrathNicol we believe that ***in advance*** of considering changes to the current system there are some key questions that the PC should answer in order to specifically define the issues it is endeavouring to resolve. That is, the problem needs to be clearly articulated before solutions are contemplated.

Importantly, we believe that many of the concerns raised with the current system are anecdotal and poorly supported by fact and/or given disproportionate emphasis when considered in the context of the large number of cases dealt with by the system. Disproportionate emphasis commonly arises from political and media commentary which frequently accompanies a specific set of circumstances surrounding an insolvency matter, but:

i. wrongly interprets the situation; and/or

ii. inappropriately extrapolates behaviours or outcomes and manufactures inferences far beyond what is reasonable; and/or

iii. reports facts selectively or from only one side of the issue.

We believe it is critically important that the PC underpins any proposed changes to the current framework on rational, fact based analysis to ensure that any changes will lead to genuinely better outcomes for the breadth of affected parties, not only to the loudest complainant.

Before listing the key questions which we recommend the PC answer in order to distil the actual problems to be addressed by reform, it is important that I clarify McGrathNicol's general position on the industry as follows.

1. We support any well targeted initiatives which improve the outcome for stakeholders; we are not irrationally wedded to the current system.
2. We believe that the Australian system works better than it is generally given credit for and minor tweaks are required rather than wholesale change.
3. People and commentators variously point to the UK or the US systems and claim they are universally superior to ours. We don't share that view. There are elements of those respective systems which we can selectively adopt and integrate into ours to improve it, but, as a whole, each of those systems have their own flaws and are unlikely to sit well in the Australian business culture. We do not favour replacing our system with either of those.
4. There is no such thing as a perfect insolvency process or regime. Insolvency is a highly contentious field which by definition involves commercial loss, usually to multiple parties. In most insolvencies, ***wherever they occur in the world,*** many stakeholders are aggrieved. Moreover, stakeholders commonly have competing interests so, by definition, a positive outcome for one risks a heightened level of angst or dissatisfaction for another. For this reason the PC needs to be careful that it is responding to genuine problems with the system rather than public outbursts which are often the venting of disappointment and frustration at an unfortunate set of specific circumstances and/or personal outcome rather than a genuine flaw in the efficacy of the system.
5. One size doesn't fit all. Small and assetless insolvencies require a different process to large, complex trading businesses.

6. The current system is far more flexible and supportive of debtor led business restructuring than it is given credit for. In our experience it is very rare that a genuinely viable company enters insolvency (we can't think of an instance where this has occurred). The clear trend in Australia since the early 1990s has been for all major banks and financial institutions to support and attempt to rehabilitate problem accounts for an extended period, often many years, before an insolvency appointment solution is implemented. Other than in cases of fraud, insolvency is considered the final and least attractive option by financiers and the last resort. In the case of smaller businesses, which are more commonly tipped into insolvency by non-bank creditors (e.g. trade creditors or the ATO), the fact they commonly have few, if any, assets remaining at the commencement of a formal insolvency means, by definition, thay they have traded for as long as they possibly can leading up to an appointment giving them the longest possible opportunity to restore viability. *(Again, the question arises as to whether this is the objective of the system in any event.)*

7. There are issues in the sector which are better characterised as failures of enforcement than failures of the system itself. These issues are evidenced by:

    i. the vast majority of adverse liquidator reports to ASIC as to director behaviour go nowhere;

    ii. the challenge presented by a lack of resources to pursue claims when companies are left assetless; and most problematically

    iii. the rise of the "unregulated insolvency sector" – businesses outside the regulated practitioner sector which engage with vulnerable businesses and re-organise affairs to the detriment of bone-fide creditors, take a slice of any value and leave it to a registered liquidator to clean up the tailings, secure in the knowledge that it is improbable that any consequences will follow.

8. It isn't possible to "have one's cake and eat it too". There is a natural tension between:

    i. facilitating the early appointment of insolvency administrators, when there are assets and goodwill remaining within the business which present options for successful restructuring and/or facilitating an improved return to creditors; and

    ii. giving management as much time as possible to engineer the turnaround of the business such that unless they succeed, by the time an appointment occurs the business has been drained of liquidity and goodwill such that there is minimal asset value left to satisfy creditors and little hope of a successful restructuring occurring such that the business can return to solvent trading.

    This natural tension means that trade-offs must occur and the rights of some stakeholders will be favoured over others.

Key questions to frame the review process

We believe there are 5 key questions PC should answer to clarify the specific issues to be addressed by any reform. They are as follows.

1. What are the actual issues PC is seeking to address?
2. How significant is the issue based on fact rather than "noise"?
3. Does the issue apply across the entire industry or to specific "pockets"?

4. What key tenets does PC wish to honour? Creditor rights Vs entrepreneurial incentive? Employee rights Vs trade creditor rights? Cost and ease of implementation Vs robust process and prevention of abuse? *(Each of these are in natural tension with each other more often than not and so the promotion of one often leads to the undermining of the other.)*
5. Has PC looked at best practice elsewhere? We suggest that the Australian system only requires tweaking to get there for larger jobs. We are unsure if there is a standout model for smaller jobs.

In addition, in respect of proposed reforms, a further key question needs to be answered. What will be the behavioural response of the stakeholders?

Initial thoughts on Roundtable topics

In relation to those topics which attracted the most discussion at the Roundtable, we provide brief comments on our stance on each below.

1. "ipso factor" clauses: McGrathNicol is strongly in favour of introducing protection against ipso facto clauses in insolvency. We are of the view that this is the single most important issue requiring resolution to ensure that the voluntary administration legislation achieves its intended objectives.
2. Director moratorium: We believe the Director Moratorium concept is theoretically appealing in that it promotes early, well advised action by directors to restructure to avoid insolvency. Importantly it also provides protection to those professionals who have capability and experience to assist and enhance the prospect of successful restructuring. So whilst we do not oppose the proposition, we are ultimately sceptical as to its impact:
    i. In small owner operator, personally guaranteed debt businesses, absent effective enforcement (which is the case), the threat of insolvent trading holds no fear for directors. Accordingly, it is improbable that the Directors Moratorium will impact behaviour – directors will likely continue to "carry on in hope". Indeed there is some risk that it will exacerbate or condone trading beyond a reasonable point.
    ii. At the larger end of business it has not been our experience that boards pre-emptively or inappropriately seek to enter formal insolvency to avoid personal liability. Moreover, if the "ipso facto" issue is resolved, a key obstacle to effecting restructuring through the VA process will be removed obviating the need for such a Moratorium.
3. Panel: Whilst this initiative has academic merit in certain circumstances we suspect that it would in fact only be preferable to the current mechanisms in a small number of cases in Australia such that the cost and disruption of implementing the change renders it impractical.
4. Standard process and costing for smaller jobs: Whilst we do not practise in this space, as a general rule we think this initiative has great merit and could avoid a lot of wasted practitioner time and effort and remove significant creditor angst and confusion over due process and insolvency costs. The policy position on cost of insolvency process Vs investigation of director/corporate behaviour should critically guide the direction to be taken with respect to smaller insolvencies.

Conclusion

In summary:

1. It is timely to review the effectiveness, efficiency and fairness of the insolvency regime in Australia.
2. It is important that problems identified for attention are based on fact rather than myth.
3. The insolvency regime in Australia is generally sound and effective with a robust legal framework (both legislative and Court). Whether by design or accident, and contrary to media and public perception, almost all businesses already get an extended opportunity to succeed before an insolvency appointment occurs.
4. Notwithstanding, targeted improvements to the regime are warranted and would be well received, by the profession and the community.

Thank you for the opportunity to participate in the Insolvency Roundtable. Please contact me if you have any queries in relation to this submission or would like to discuss any of these issues in more detail.

Yours faithfully

Peter Anderson

Partner

CC:
no copy list

Enclosure(s):
no enclosures