



**ASIC**

Australian Securities & Investments Commission

## Regulatory issues impacting on insolvency

*An address by David Knott , Deputy Chairman, ASIC, to the National Conference of the Insolvency Practitioners Association of Australia (IPAA), Adelaide, Friday 13 October.*

[Introductory remarks]

### **A firm Constitutional footing**

It is curious to reflect on the impact that insolvency issues have had on the evolution of Australian corporations law over the past few decades. You will all recall the problems that arose from inconsistent court rulings in the insolvency jurisdiction, particularly relating to statutory notices of demand and deemed insolvency, which contributed to the push for a truly national corporations law during the 1980s.

It is therefore ironic that, more than a decade later, insolvency law has provided the impetus for the constitutional challenges that have afflicted our national scheme and dominated the Commission's agenda over the past twelve months. Often we find insolvency providing precedent setting law of profound interest. Rarely is it as interesting as the outcome in the four High Court cases collectively referred to as *Re Wakim*<sup>1</sup>.

I don't need to revisit the outcome of that case for this audience. Suffice to say, that from the date of that decision we entered a period of great uncertainty. We took the view that we could not allow that uncertainty to prevent the regulatory and enforcement work of the Commission being pursued. However, there were serious implications across a raft of matters on hand, including applications to

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<sup>1</sup> [1999] HCA 27 (17 June 1999)

transfer litigation from the Federal Court into State Supreme Courts and challenges to specific State remedial legislation<sup>2</sup> - all of which added cost, delay and uncertainty to the outcome of enforcement proceedings. More than once we have found ourselves this year arguing constitutional issues in the High Court and we were obliged to stay several of our enforcement actions after the decision in the *Hughes* case.<sup>3</sup> It is fair to say that in the months leading up to August this year the national *Corporations Law* and its administration was approaching crisis point.

During this period, the insolvency industry was also coping with the inconvenience caused by the loss of the Federal Court as a venue for appointments and litigation and I know that practitioners were eagerly awaiting an agreement to place the *Corporations Law* on a firmer constitutional footing.

That agreement was secured at a meeting of the Commonwealth and States held in Melbourne on 25<sup>th</sup> August 2000. I'd like to spend a minute talking about the outcome.

The question at issue was how to move from the current position under which the law is a matrix of Commonwealth and State laws glued together by agreement, to a situation where the law is clearly and indisputably a law of the Commonwealth.

Some States preferred that this be achieved by referendum. The Commonwealth favoured a referral by the States of their relevant power. As you would expect, the result is a compromise.

The States were unwilling to refer a broad corporations power to the Commonwealth for fear that it might be used to make future laws binding on companies in unintended areas, such as trading hours and industrial relations.

Instead it was agreed that the States will refer only sufficient power for the Commonwealth to re-enact the *text* of the *Corporations Law* and the *ASIC Law* as exclusive laws of the Commonwealth. The referral includes power by the Commonwealth to amend those laws from time to time, subject to obtaining the agreement of at least 4 States.

In order to implement these arrangements the State Parliaments must pass the necessary referral legislation, together with laws that validate all actions that have been implemented in the preceding

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<sup>2</sup> see *Residual Assco Group Limited v Spalvins* [2000] HCA 33 (13 June 2000)

<sup>3</sup> *The Queen v Hughes* [2000] HCA 22 (3 May 2000)

decade under the matrix scheme. The Commonwealth must re-enact the *Corporations Law* and the *ASIC Law*, so that they have their constitutional legitimacy underpinned by both the referred State powers and the Commonwealth's own powers where relevant. It is a substantial job of work and it is targeted for completion by 1 January 2001.

Other points to note are:

- The Federal Court will regain jurisdiction to hear corporations matters including liquidator appointments and insolvency litigation. The State Supreme Courts will continue to be available through cross vesting provisions. It is part of the agreement that ASIC will make use of both the Federal Court and the State Supreme Courts, as indeed we have always done.
- The Alice Springs Agreement which established arrangements for on-going participation by the States in the oversight of corporations law remains in force, with the increased requirement for State approval of amendments which I have mentioned. The arrangements for the distribution of funds received from the incorporation of companies also remains in place.
- The referral of powers is subject to a five year sunset clause, at which time the referrals will cease unless extended. There is a continuing agenda with at least some States that within the first five years a referendum should be held to place the constitutional foundations of the corporations law – and indeed other Commonwealth/State co-operative schemes - on more sound constitutional footings. It would seem, therefore, that we may have at least one more stage of constitutional evolution to survive before we can finally say that the future of the *Corporations Law* as an undisputed national law is assured.

However, in the interim, implementation of the recent agreement will restore much needed certainty to the application and administration of the law and should, we hope, remove any questions about the validity of actions and proceedings taken over the years since 1991. Experience would caution us to expect constitutional challenges to some aspects of this latest package, but the combined powers and political commitment of the States and Commonwealth should be adequate to defend them.

There are probably some in this audience who have been bemused that the insolvency jurisdiction should be caught up at all in this constitutional imbroglio, given that section 51(xvii) of the Constitution empowers the Commonwealth Parliament to make laws with respect to bankruptcy and insolvency. At one point in the debate there were suggestions that the Commonwealth should go it alone in areas where it has undisputed powers, which includes a significant proportion of the content of the *Corporations Law*. However, the prospect of a two-tiered system of corporate regulation, with the States governing some aspects and the Commonwealth others, was recognised as being retrogressive and unacceptable (both commercially and politically), and the Corporations Law has thankfully survived intact as an integrated package.

### **The requirement for a strategic approach to regulation.**

So much for the constitution. But what about the way in which we currently exercise our regulatory powers?

There are those of you who think we are not doing enough; or that we could do our work to better effect. I don't want to dodge those issues. My introductory comments reflect a personal view that the time is right for us to review these matters to see whether better outcomes are achievable. I want that to be part of our work program over the next 12 months.

But we need to establish at the outset realistic parameters for this work, just as we do in all the other areas of our activity. ASIC will never have sufficient resources to pursue every act or omission that constitutes wrongdoing. A strategic approach is both desirable and necessary. No citizen would consent to fund a law enforcement machinery of sufficient size to pursue every single breach of law. Members of society choose to allocate their funds across many competing needs and wants. They set priorities. In terms of law enforcement they expect that those with responsibilities will make wise choices on their behalf as to the best use of resources to achieve a result – and the expected result is to minimise harm.

We need to make strategic decisions, based on our assessment of the market, as to what areas of activity are most problematic at any particular point in time and to design responses that will optimise *regulatory outcomes* within *affordable costs*. That is a constant juggling act for an agency like ASIC. It is sometimes an uncomfortable position to be in; and there is the absolute certainty that no vested interest will ever feel that they have an adequate portion of the pie. The challenge for us is to focus hard on being strategic and to communicate that thinking to our various stakeholders.

This need for a strategic approach to regulation and enforcement applies across the whole range of our functions. It resulted last year in 25 people being gaoled on ASIC charges and some 60 being banned from their industries for a variety of terms, and in 16 cases for life. It has resulted in the increasing use of national compliance campaigns in areas ranging from reporting of directors share trading; disclosure in the superannuation industry; continuous disclosure by listed companies and selling practices in disability insurance.

Closer to home, we employed the same approach in the insolvency jurisdiction after concluding that voluntary administrations should be given some priority by ASIC. Voluntary administration was a relatively new mechanism where practices and precedents were still developing; it encompassed an increasingly large share of external appointments, with little supervision by the courts.

It was also an area where ASIC had received some enquiries and complaints. VA's have now been the subject of surveillance in four regions and there is some remaining work to be carried out under that program. We are very supportive of the VA process and are keen to ensure that it works efficiently, with proper disclosure of relevant information, including fee information, to creditors; and without reduction in the reporting of suspected misconduct to ASIC. We have discussed with the IPAA the need for recognised standards and have noted the recommendations and commentary of others.<sup>4 5</sup>We believe that by addressing potential problems of VAs in this manner we can help to deliver a widespread regulatory outcome far more cost effectively than the "hit and miss" tactic of focussing on individual problems.

Having said that, we must never underestimate the importance of visible enforcement. We need to take time out to identify areas of growing concern and to consider whether barriers to effective enforcement are set too high. Insolvent trading, phoenix companies and assetless companies all come to mind as warranting additional public policy appraisal.

## **Insolvent trading**

Insolvent trading matters are notoriously complex and resource intensive because of the evidentiary hurdles that must be jumped in order to sustain a prosecution. On the one hand, it is entirely appropriate that our system should be sympathetic to honest directors who succumb to corporate

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<sup>4</sup> "A Standard for Content of Administrators Reports", A Draft Discussion Paper prepared by David J Kerr published in the *Australian Insolvency Journal*, July – September 1999.

<sup>5</sup> "Corporate Voluntary Administration Final Report", prepared by the Legal Committee of the Companies and Securities Advisory Committee, June 1998.

failure. The limited liability company remains the mainstay of our economic life and there is a natural reluctance to second guess and punish directors and managers with the benefit of hindsight. Yet these same legal hurdles that protect the truly honest, also serve to hinder effective action against the dishonest and seriously negligent. It is not just the legal burden of proof which is at issue here, but perhaps more importantly the huge evidentiary difficulties associated with establishing the period of insolvency, proving individual debts, dealing with creditor indulgences, documenting the particulars (often in cases where the documentary trail is weak), seeking reliable evidentiary support from creditors who are usually geographically dispersed and often reluctant to become witnesses - and all this being preliminary to dealing with the intent of the directors and managers.

Many in this audience will relate to the difficulties of establishing, to the required legal standards, that directors were acting *unreasonably* or *dishonestly* in expecting that things would come good; that their financial saviour or big project or merger would come home; or that the projections and forecasts from management or experts supported the case for continued trading. These are typical challenges for ASIC when assessing enforcement prospects.

By way of example, one matter which we will shortly bring before the Courts has caused us to interview over 100 creditors and take about 60 statements and affidavits along with numerous exhibits. The total brief runs to 1500 pages of witness statements/affidavits. The investigation has required an extensive examination of source documents and has taken approximately 27 months from the time it was resourced, due solely to the difficulties in compiling the evidence.

Under these circumstances, it is simply not realistic to imagine that ASIC can properly investigate, let alone prosecute, every suspect case of insolvent trading referred to us. Yet we are all frustrated when we see situations which fail the smell test, but which escape without penalty. I do not rule out the possibility that renewed enforcement focus by ASIC, involving clearer national priorities and objectives, may have a part to play in attacking this issue. But I do not accept that this is a problem of lack of will or capability on the part of the regulator. I believe that if public policy requires greater accountability on the part of directors and managers for insolvent trading, consideration will need to be given to stricter liability and a reduction in the evidentiary requirements of proof. I make that comment notwithstanding the partial lowering of the threshold for criminal proceedings which became operative in March this year<sup>6</sup> and which, in my view, is a step in the right direction. I also

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<sup>6</sup> *Corporate Law Economic Reform Program Act 1999* (No. 156 of 1999).

recognise that the further lowering of barriers to prosecution raises very serious matters of public policy that I would not expect to be easily resolved.

## **Phoenix and assetless companies**

Phoenix and assetless companies raise similar difficulties for ASIC but, in addition, have their own peculiar characteristics. They both continue as enforcement problem areas, despite a concentrated campaign on our part some years ago to research phoenix companies and to implement both educational and enforcement initiatives.<sup>7</sup> We have had some success in banning from management persons involved in two or more corporate failures within nominated time periods,<sup>8</sup> including 42 such bannings last financial year.

But even our banning remedies are complicated by the need to establish that the person is "managing a corporation" within the meaning of the law because, as you know, such people are usually ingenious in disguising their control through nominees or other devices.<sup>9</sup> In any event, while banning may be a helpful prevention of future harm, it does nothing to assist the creditors of the already failed company. One of the recurring difficulties confronting effective recovery in phoenix cases is proving the fraudulent transfer of assets. Transfers which may appear to be suspect often transpire to be legitimate under the law; and in other cases recovery is primarily reliant on the exercise of the liquidator's powers. While this may theoretically still leave ASIC options to pursue criminal conduct offences, the burdens of proof and evidentiary issues associated with insolvencies again operate in practice to severely constrain such outcomes.

In assetless companies, of course, the position is even more difficult because of the liquidator's incapacity to fund recoveries.

In making these points this morning I do not intend to convey that insolvency enforcement is unachievable or that we should accept that improvements are unattainable. I would reject both those propositions. However, I do think that practitioners sometimes underestimate the complexities confronting the regulator in this area and believe that our forward planning needs to address not only opportunities for improved outcomes; but also the difficult question of where the balance of

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<sup>7</sup> P.12 *Phoenix Activities and Insolvent Trading*, Darren A Barlow, National Intelligence and Analytical Service.

<sup>8</sup> Refer current section 206D of the *Corporations Law*.

<sup>9</sup> For an illustration of the difficulties of proving a person was managing a corporation and the interpretation of the word "managing" refer to the prosecution and subsequent appeal in South Australia of Eric John Griggs [SASC 405 of 1999].

public interest lies between lowering enforcement hurdles and maintaining adequate incentive for commercial risk taking.

Before concluding on this topic, I need to address what I consider to be a mistaken view of the closing of our small business unit. It has been suggested that disbanding this unit is a major setback for our insolvency work. I disagree.

Although the small business unit was responsible for some insolvency matters, it has never been the driver of major insolvency outcomes. The inhibitors to those outcomes are the ones I have canvassed this morning, not the relatively minor change which we have made to our structure in recent months. Even if that unit was still in place the problems we have discussed this morning would demand attention. Assetless companies, for example, may often be quite small. But the existence of our small business unit was never an effective means of addressing the assetless companies problem. In my view the policy of giving liquidators the front line role in establishing prima facie breaches of law and recovery of payments is the right policy. The real question for Governments is how best to equip and fund them for that role. Governments might well consider, for example, whether the current apportionment of funding between personal bankruptcy and corporate insolvency is correctly balanced. Perhaps the Harmer Report's recommendation<sup>10</sup> of an assetless companies fund should be revisited, particularly if official liquidators exercise greater discretion to decline appointments. On these big issues that matter most, I think the focus on ASIC's small business unit is a distraction.

There are two further points to make on this issue. First, the dissolution of that unit does not mean that all of its functions are redundant. Much of its substantive work will continue through other divisions of ASIC. For example, the banning of persons from management and the removal of bankrupt directors from the ASCOT database will continue.

Secondly, we have made a decision that routinely prosecuting directors for failing to produce records or Reports as to Affairs to liquidators is a resource intensive means of achieving compliance. That was a significant activity of the small business unit. It was rarely effective in cases of missing directors; and fining people was not necessarily concomitant with the production of information. We believe that in the vast majority of cases the receipt by directors of a letter from ASIC referring them to their legal obligations will prove effective to ensure compliance. That is the

process that we are now trialing. We will review this with you in 12 months time to see whether there has been any discernible difference in compliance behaviour.

There is another related initiative of which you may be unaware. We have recently updated our publication "The Watchdog's Guide" which is given to newly incorporated companies to include a list of books and records that we believe should be maintained under the Corporations Law. This should not only be helpful to first time directors, but should also help to counter assertions in times of difficulty that they were unaware of their record keeping obligations. I acknowledge with thanks the contribution of the IPAA in finalising this work with us.

### **Some recent ASIC outcomes**

So far this morning I have focussed on some of the difficulties and concerns that currently confront the industry and the regulator. The better we can understand those problems the more likely it is that we can do something about them. But I need to turn to some of the more positive aspects of our work so that I don't leave behind an incomplete picture.

ASIC has not been inactive in the insolvency area. Part of our activity involves intervening to create awareness of directors' obligations to avoid insolvent trading. Surveillance can involve obtaining books and records through the service of notices, seeking budgets and forecasts, and querying public announcements (or the lack of them) in the case of public companies. Despite the issues discussed this morning, we have been successful with a variety of interventions ranging from prosecutions, civil penalty orders, banning orders, negotiated settlements and enforceable undertakings. There have also been instances where warnings to companies have resulted in them appointing external administrators or retaining specialist financial advice.

Let me give you some examples of recent public outcomes. They have included:

- recovery of moneys for creditors in a failed Tasmanian company and the conviction of the principals for insolvent trading offences;
- the negotiated recovery of moneys for creditors and employees in the Cobar Mines closure;
- the conviction and gaoling of Melbourne accountant John McNabb for insolvent trading and related offences;

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<sup>10</sup> General Insolvency Inquiry. The Law Reform Commission, Report No 45, vol 1, p337-358.

- successful applications for court appointed liquidators in cases involving the failed WA finance broker, Graeme Grubb;
- the winding up of 47 companies which were part of the property development group, Lifestyle Property Investments;
- and the court appointment of receivers and managers to companies alleged to be involved in illegal fundraisings.

There is, in fact, an insolvency connection with much of ASIC's enforcement work, whether it be the insolvency of parties involved in the Finance Broking Industry in WA; or the bankruptcy of people like Geoffrey Dexter currently facing charges over the collapse of the Wattle scheme; or the winding up of companies where there have been alleged breaches of director's duties or illegal fundraising.

Unfortunately there are also times when we have to point the blowtorch at practitioners themselves. Over the past two years we have taken 13 matters involving liquidators to the CALDB and there are some further referrals in the pipeline. The outcomes from these matters range from suspensions of registration to undertaking peer reviews, and are usually accompanied by an order for costs. Occasionally it is suggested that we are over zealous about technical breaches. But any action initiated by us is heard by an independent Board from which there is further appeal to the AAT. Our complaints are overwhelmingly upheld by the Board whose decisions are, in turn, only seldom reversed by the tribunal. I should add that the general reaction from the profession is to acknowledge that this action is necessary to protect its good reputation.

## **Information and communication**

My closing comments are directed to information and communication.

The quality of insolvency policy and regulation is dependent in no small way on both information and communication. Through the IPAA, and with many individual firms and practitioners, we have a solid relationship platform on which to build improved channels of information exchange.

To assist that process, the Commission recently approved a new systems project that will allow complete electronic lodgement of forms and reports from insolvency practitioners directly to ASIC. The high priority given to this project, accelerating it above many competing e-commerce ambitions

within ASIC, reflects our desire to not only facilitate the exchange of information between us, but also to improve the quality and analytical capability of that information. Better quality statistical information, delivered electronically and capable of interrogation, will enable industry, Government and ASIC to identify and address emerging stress areas. For this to work properly, we need to ensure that the profession is actively involved in the design of the project so that we end up with an affordable system that adds real value to both sides. We are in the early stages of discussion with the IPAA to ensure that industry consultation is managed effectively.

From your perspective, the added value should be reflected not only by reduced time and cost in preparing and submitting information, but also in more meaningful statistics. We have recently concluded work to improve insolvency appointment statistics by eliminating double counting, and these are now posted on our website. But there is a limit to how much can be achieved without a purpose designed system, and the Commission's approval of the project opens the way to a new approach which should serve all of us better in the years ahead.

One of our expectations is that the flow of section 533 report information will improve with electronic enhancement. Currently, we are finding problems in that area: we are receiving less reports; they are often late; do not always contain information in the most useful format; and, of course, the s438D equivalent is not mandatory in VA's which are playing an increasingly important role in the insolvency scene.<sup>11</sup> Apart from urging all practitioners to be mindful of their statutory responsibilities to report to ASIC (which I do this morning) we need to examine useful ways to supplement formal reporting obligations, so that the exchange of information which is critical to effective policy making and enforcement is not unnecessarily obstructed. The Commission has in the past exhorted the profession to tell us early about suspected misconduct. Delays not only exacerbate the evidentiary complexities that I have described this morning, but also make it more difficult for ASIC to give an old matter priority over a more current offence arising elsewhere in our portfolio.

Two other current initiatives warrant mention under this heading of information and communication:

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<sup>11</sup> *Voluntary Administration in Australia – A Timely Review*, National Intelligence Analytical Service, July 2000. This is an internal ASIC document which shows that between 1/7/93 and 30/6/99 there were 14,259 administrations in Australia and only 8% of administrators lodged s438D Reports. This compares with 42% of liquidators who lodged s533 reports over the same period.

First, we are completing a comprehensive Memorandum of Understanding with our co-regulator in the insolvency industry, the Insolvency and Trustee Service Australia (ITSA). The MOU will allow joint liquidator/trustee surveillance exercises and taskforces to examine offences where a director is bankrupt. That is a sensible development between two agencies wishing to optimise resources and information in appropriate circumstances.

Secondly, we are now in the final stages of industry consultation on a rewrite of ASIC's policy statements 24 and 40, dealing with liquidator's registration requirements. During the course of this rewrite it has appeared to ASIC that the distinction between registered and official liquidators is becoming problematic, especially given that the issues arising in VA's (which require only a registered liquidator) are often as complex as those in a court liquidation (which requires official liquidator status). This may be an issue for future legislative reform, particularly as the 1997 report of the working party reviewing the regulation of corporate insolvency practitioners<sup>12</sup> has yet to be addressed.

## **Conclusion**

Finally, ladies and gentlemen, let me emphasise that we want both the IPAA and practitioners to tell us what you see as the significant systemic issues for ASIC. Is it, for example, VA's, dot-coms, non-payment by companies of superannuation contributions, or practices in particular industries which give rise to greater than usual insolvency risk? We want you to input through IPAA at a national and regional level, supplemented where appropriate by direct contact with ASIC officers. We have established in ASIC a network of insolvency contact officers in each region to ensure that there is regular liaison with the IPAA and also that there is national consistency, as far as possible, in the way that ASIC handles insolvency issues. I encourage you to recognise the reality of financial constraint and to focus, with us, on the best strategic use of our resources.

In the meantime, I have attempted this morning to give you some understanding of our operating environment; our need to manage the use of finite and competing resources strategically; some of our current initiatives in the insolvency jurisdiction; and our commitment to a 2001 work program that includes insolvency as a high priority. I thank the IPAA for the opportunity of presenting these matters to you this morning; and I thank you for your hospitality and attention.

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<sup>12</sup> "Review of Regulation of Corporate Insolvency Practitioners – Report of the Working Party", Commonwealth of Australia, June 1997.