LEVEL

TWENTY SEVEN

CHAMBERS

Insolvency Law Reform Act and Insolvency Practice Rules – some of the essentials

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Introduction

In September 2010, the Senate Economics References Committee released its report on the regulation, registration and remuneration of insolvency practitioners in Australia (**2010 Senate Report**). This report, as well as the Explanatory Memorandum and the parliamentary debates over the Insolvency Law Reform Bill, make it clear that a critical motivation to this suite of reforms was the need for "all stakeholders have confidence in the insolvency regime and its practitioners and regulators".[1] In considering a number of well-publicised cases of misconduct, the Senate Report sought to determine whether they were isolated incidences, or whether the problem was more widespread. The Report doesn't in fact make a clear conclusion on this point, rather considering that as a result of "the importance of maintaining community confidence in the insolvency regime" and the "potential for stakeholder dissatisfaction from the insolvency process", "significant reform should not wait for precise data verifying the presence of regulatory failure".[2]

As a result, the *Insolvency Law Reform Act* 2016 (Cth) (**ILRA**)[3] passed both houses on 22 February 2016, receiving royal assent on 29 February 2016. However, it did not commence until just over one year later, on 1 March 2017, and as at the date of writing some provisions are still yet to commence. In addition to the 2010 Senate Report, the Act follows a number of reports and reviews which considered the efficacy of the Australian regime and made recommendations for change,[4] culminating in the Productivity Commission's

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[1] Senate Economics References Committee, "The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework" (September 2010) (**2010 Senate Report**) [1.2]; see also Commonwealth, *Parliamentary Debates*, House of Representatives, p 14637, (Assistant Minister to the Treasurer); Explanatory Memorandum, *Insolvency Law Reform Bill* 2015 (**Explanatory Memorandum**), [2.5]-[2.6].

[2] 2010 Senate Report, p 63 [5.57].

[3] See also *Corporations and Other Legislation Amendment (Insolvency Law Reform) Regulation* 2016 (Cth); *Insolvency Law Reform (Transitional Provisions) Regulation* 2016 (Cth); *Insolvency Practice Rules (Corporations)* 2016 (Cth); *Insolvency Practice Rules (Bankruptcy)* 2016 (Cth).

[4] See e.g. Australian Law Reform Commission, General Insolvency Inquiry, Report No. 45 (Canberra, 1988); Review of the Regulation of Corporation Insolvency Practitioners, Report of the Working Party (June 1997); Parliamentary Joint Committee on Corporations and Financial Services, "Corporate Insolvency: a Stocktake"(June 2004); The Senate Economics References Committee, "The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework" (September 2010); National Innovation and Science Agenda, "Improving bankruptcy and insolvency laws".

Report in September 2015.[5] The intent behind these changes is said to be *inter alia* to remove unnecessary costs and increase efficiency in insolvency administrations, align the registration and disciplinary frameworks that apply to registered liquidators and registered trustees, improve the powers available to the corporate regulator to regulate the corporate insolvency market; and improve overall confidence in the professionalism and competence of insolvency practitioners.[6]

Perhaps unsurprisingly then, in a number of respects the changes brought in by the ILRA are not altogether that groundbreaking. That is not to say that the ILRA does not introduce change – and some significant change at that – but rather serves to highlight that to an extent it draws on existing regimes. For example, some elements of the new corporate insolvency regime are based on existing practices in personal insolvency regulation. Further, some of the changes have also been adapted from other external sources, such as the ARITA Code of Practice or ASIC Guidelines.[7]

This paper intends to highlight and provide an overview of a few key changes brought in by the ILRA, its regulations and the Insolvency Practice Rules. In particular, this paper focuses upon the reforms which are said to, or are intended in some way to, impact upon public confidence in Australia's insolvency regime. As will be seen, there is little doubt that this was a key (if not the principal) motivation behind the reforms, even without any real certainty as to the degree to which public confidence might be lacking. Accordingly, in the author's view, this provides an apt position from which to begin analysing and assessing the effect of the reforms, as they begin to take effect. For simplicity, this paper will focus predominantly on the changes to the *Corporations Act* 2001 (Cth), but readers should note that many of these changes appear in similar terms in respect of personal insolvencies, and that the ILRA also makes other consequential amendments which should be paid careful attention.

Content of the Reforms – Regulation of Liquidators and Registered Trustees

As the reader may now apprehend, many of the ILRA reforms are quite obviously aimed at increasing the regulation and transparency of liquidator's conduct, for example: a more rigorous process to becoming a liquidator, bringing corporate insolvency practitioners into line with the personal insolvency regime; a requirement for renewal of registration every three years; greater powers of creditors, including powers of removal of liquidators; and new powers of oversight vested in ASIC and the Court. By incorporating existing obligations and making the system more coherent, it is evident that the purpose of such reforms is not to necessarily improve the result of having better liquidators and registered trustees – although it may

[5] Productivity Commission Inquiry Report, No. 75, 30 September 2015.
[6] Explanatory Memorandum, p 3.
[7] For example, the concepts of "necessary work" and "properly incurred" which are addressed below in respect of liquidator's remuneration are taken from the ARITA Code of Practice.

have that effect – but to improve public confidence by having a system that itself "promotes a high level of professionalism and competence".[8] That is, the changes themselves ought to improve public confidence, not merely the "improved" liquidators that they might produce.

First, the ILRA introduces more rigorous processes for registration as a liquidator, intending to bring the registration process for liquidators into line with the position for personal insolvency practitioners. An application for registration as a liquidator must be referred to a committee,[9] who must decide that the applicant should be registered if it is satisfied that the applicant meets the criteria set out in s 20-20(4), which include *inter alia* that the applicant:

(a) has the prescribed qualifications, experience, knowledge and abilities (these are now set out in the Insolvency Practice Rules (Corporations) 2016 (Cth));[10]

(b) will take out:

  a. adequate and appropriate professional indemnity insurance; and

  b. adequate and appropriate fidelity insurance;[11]

 against the liabilities that the applicant may incur working as a registered liquidator; and

(c) has not had his or her registration as a liquidator cancelled within 10 years before making the application, other than in response to a written request by the applicant to have his or her registration cancelled; and

(d) is otherwise a fit and proper person.

Further, in making its decision, the committee must interview the applicant and may require the applicant to sit for an exam.[12]

Second, registration of liquidators is no longer indefinite, but expires after three years. One motivation behind this is to give greater oversight to ASIC over liquidator's compliance with, *inter alia*, requirements to maintain insurance.[13] Prior to the amendments, ASIC's approach was essentially to undertake targeted or random surveillance of liquidator's compliance with their obligations to maintain adequate insurance. Strong views were expressed in the 2010 Senate Report that this was inadequate in that few checks were undertaken and there were insufficient penalties for non-compliance.[14] A licensing regime with a regular renewal process was suggested as a mechanism for reform. The renewal process, by requiring evidence of

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[8] Explanatory Memorandum [2.6].
[9] See generally *Insolvency Law Reform Act* 2016 (Cth), Schedule Two (**Corporations Schedule**), ss 20-10 to 20-25.
[10] See rule 20-1 of the Insolvency Practice Rules (Corporations) 2001 (Cth).
[11] This is not itself a new requirement: see *Corporations Act* 2001 (Cth) s 1284 (prior to the introduction of the ILRA).
[12] See Corporations Schedule, s 20-20(2). This is in line with actions taken by ASIC to include greater rigour in its processes: 2010 Senate Report, p 83 [7.15],
[13] See e.g. 2010 Senate Report.
[14] 2010 Senate Report, p 86 [7.28]

maintenance of appropriate insurance, may be sufficient to alleviate these concerns; however, it is the ancillary amendments which accompany it which will be likely to have a real impact upon liquidator compliance. For example, the ILRA increases the penalties for failure to maintain appropriate insurance (1,000 penalty units, up from 5 penalty units under the prior provision of the *Corporations Act* 2001 (Cth)),[15] the liquidator's annual return must include evidence that adequate and appropriate insurance is being maintained[16] and he or she is required to advise ASIC if the insurance lapses,[17] and ASIC is entitled to suspend, issue a show-cause notice, or cancel a liquidator's registration if he or she does not have the appropriate insurance.[18]

Third, powers are vested in ASIC to prevent liquidators from taking on further matters,[19] to suspend[20] or to cancel a liquidator's registration,[21] or to issue the liquidator with a "show-cause" notice[22] in certain circumstances.[23] These powers are more detailed and more expansive than under the prior regime.[24]ASIC may also appoint another registered liquidator to carry out a review into a matter that relates to the external administration of a company.[25]

ASIC is not the only entity to receive additional powers under the ILRA changes. An "industry body" may lodge with ASIC a notice stating that the body reasonably suspects that there are grounds for suspension or cancellation of a liquidator's registration, or to give a registered liquidator a show cause notice, or to impose a condition upon his or her registration.[26] The Court also has further detail in its powers granted under the Act.[27]

Finally, creditors have received significantly greater powers under the Act. This is designed to improve creditor engagement and oversight. Perhaps most significantly, these include the power to remove the external administrator by majority resolution and without reference to the Court.[28] It is anticipated that this

[15] Corporations Schedule, s 25-1.
[16] Corporations Schedule, s 30-1.
[17] Corporations Schedule, s 35-1, with a maximum penalty of 100 penalty units.
[18] Note also the ASIC Regulatory Guide 258 which provides some guidance as to the scope of coverage required: RG 258.244-258.277.
[19] Corporations Schedule, s 40-15.
[20] Corporations Schedule, s 40-25
[21] Corporations Schedule, s 40-30.
[22] *Insolvency Law Reform Act* 2016 (Cth), Schedule One (**Bankruptcy Schedule**) and Corporations Schedule, s 40-40. If a show-cause notice is issued and ASIC either does not receive an explanation, or is not satisfied with the explanation, it may refer the matter to a committee to determine what ought to happen with the liquidator's registration: see 40-45 to 40-65 of both the Bankruptcy Schedule and the Corporations Schedule.
[23] Notably, in this regard ASIC has now taken over the functions of Company Auditors and Liquidators Disciplinary Board in its disciplinary function of liquidators.
[24] See *Corporations Act* 2001 (Cth) Compilation No 73, s 1290A.
[25] Bankruptcy Schedule and Corporations Schedule, ss 90-23- 90-29.
[26] Ibid, s 40-100.
[27] See further below regarding reviews of remuneration paid to liquidators.
[28] See e.g. Division 90, Subdivision D.

will be a powerful tool for creditors to ensure liquidators perform their functions satisfactorily. However, the liquidator retains a right to apply to the Court to be reappointed, which the Court may order if it is satisfied that the removal was an improper use of power by one or more of the creditors.[29] The Court may also make orders regarding the cost of the application and the remuneration of the former liquidator. The author anticipates that these provisions, if used regularly, will result in increased liquidation and associated increases in costs of the administration.

Other powers of the creditors include greater powers to request and obtain information from the external administrator;[30] to require the external administrator to convene meetings;[31] and to, similar to ASIC, appoint another registered liquidator to carry out a review into certain matters.[32] By granting greater control and transparency to creditors and shifting the regulatory burden somewhat to persons and entities with a direct interest in the proper conduct of administrations, these reforms should increase to some degree public confidence in individual administrations, and across the insolvency regime as a whole.

In addition to the above, the ILRA contains general rules for funds handling;[33] holding meetings and committees of inspection.[34] It also inserts a new definition of "relation-back" day[35] and removes the distinction between official and registered liquidators.[36] There is not scope within this paper to cover all these changes in detail, but readers are invited to refer to the many helpful publications on this topic.[37]

Reforms to Liquidator's Remuneration - Background

A further change which has strong implications for public confidence but which deserves separate attention is the issue of liquidators' remuneration. There is no question that the level of remuneration for liquidators and administrators has been a source of complaint for many years. Often, such complaints derive in part from circumstances where many or all of the available assets of an administration are used to cover the expenses of liquidation, and in particular, the remuneration of the liquidators.[38] Valid as these concerns may be, in many instances they tend to ignore the critical role played by liquidators in the insolvency regime and the necessary work that is undertaken by them.

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[29] Corporations Schedule, s 90-35(4)-(7).
[30] See e.g. Corporations Schedule, ss 70-10 to 70-15; 70-40.
[31] Ibid, s 75-15.
[32] Ibid, s 90-24.
[33] Ibid, Division 65.
[34] Ibid, e.g. 80-10 to 80-25.
[35] See ss 9 and 91 of the *Corporations Act* 2001 (Cth) as amended by the ILRA.
[36] Note that ARITA has expressed some criticism of this: circular released on 27 July 2016: http://www.arita.com.au/news-item/2016/07/27/the-end-of-the-role-of-official-liquidators.
[37] For example, ARITA and ASIC have produced a number of publications which provide helpful practical guidance on these reforms.
[38] This in no small part is a function of the liquidator's entitlement to priority out of the funds available: see e.g. *Corporations Act* 2001 (Cth) s 556(1)(a).

This has led to much discussion as to the appropriate measures to be taken. Some have suggested formal regulatory changes long before now. For example, in 1998, the ALRC recommended the creation of a statutory board with exclusive power to determine and set remuneration scales for insolvency practitioners.[39] By contrast, in 2004, the Parliamentary Joint Committee on Corporations and Financial Services insisted that liquidator's fees ought to be determined by the market, rejecting a scale of maximum fees.[40]

The Australian Restructuring Insolvency & Turnaround Association (**ARITA**) (previously the Insolvency Practitioners' Association of Australia or "IPAA") has itself issued guidelines establishing three remuneration principles: first, that the work is "necessary and proper"; second, that a claim for a fee is accompanied by "sufficient, meaningful, open and clear disclosure"; and finally, that approval is gained before the remuneration is drawn. ARITA in its former identity as the IPAA also published a recommended scale of time based charges, which were quickly adopted across the industry. However, that was criticised as being a restriction on competitive behaviour and the IPAA ceased to produce the guide in 2000.

Immediately before the introduction of the ILRA, there was no statutory direction or formula to provide a basis for calculating liquidator's remuneration. Rather, it was guided by the notion of "reasonableness" in the *Corporations Act* 2001 (Cth).[41] ARITA's current Code of Professional Practice notes that the fees of an administrator may be calculated using one of four methods:

(a) time spent according to hourly rates (which may include a prospective fee approval);
(b) a quoted fixed fee based on an estimate of costs; or
(c) a percentage, usually of the realised assets; and
(d) a success or contingency fee.

Of note is that ARITA's guidelines do not indicate a preference for the method of calculating fees, although acknowledging that most commonly these fees are charged on an hourly rate.

The absence of any clear guidance on the question of liquidator's fees prior to the ILRA has resulted in some recent and noteworthy case law in this area. In the now somewhat infamous decision of Brereton J, *In the matter of AAA Financial Intelligence Ltd (in liquidation)*,[42] his Honour acknowledged that substantially all the work claimed by the liquidator was performed; the work in all probability would have taken the time claimed; and that the rates charged by the liquidator are within the range of those charged

[39] See e.g. Australian Law Reform Commission, General Insolvency Inquiry (ALRC Report No. 45).
[40] See Parliamentary Joint Committee on Corporations and Financial Services, "Corporate Insolvency Laws: a Stocktake" (June 2004).
[41] *Corporations Act* 2001 (Cth), ss 473(1) and 504(2) and 601EE(2); *Re Wm Rose & Co Ltd* (1897) 3 ALR (CN) 65, 66; *Re Stockford Ltd; Korda* (2004) 52 ACSR 279 [38].
[42] [2014] NSWSC 1270.

by similar professionals for similar work. Notwithstanding this, his Honour commenced a crusade of sorts against the use of time-based costing as the basis of liquidators' remuneration. In that case, the amount of the remuneration exceeded the funds available to creditors. His Honour announced his "profound concern" that the liquidators appeared to be the dominant beneficiaries of the administration. His Honour also recognised that market forces were unlikely to control liquidator's charges, not least because creditors are rarely in a position to robustly negotiate a liquidator's remuneration, and that comparative cost rarely plays a significant role in the selection of a liquidator.

On that basis, Brereton J held that:

> "In my view, reasonable remuneration cannot be assessed solely by the application of the liquidator's quoted standard hourly rates to the time reasonably spent. The application of the standard hourly rates to liquidations of diverse size and complexity… does not reward liquidators for value, but indemnifies them against costs [and] disregards considerations of proportionality. Moreover, it cannot reflect some of the factors referred to in s 504(2).. In my view, while time reasonably spent at standard hourly rates is a relevant consideration, it is only one of several, should not [sic] be regarded as the default position or dominant factor, ad is to be considered in the context of other factors, including the risk assumed, the value generated, and proportionality."[43]

His Honour then preferred *ad valorem* remuneration, finding that it attracts less opprobrium than time-based costing, is more proportionate, and incentivises the creation of value by the liquidator. In the result, Brereton J determined that, having regard to the value of the assets realised, the time spent and the circumstance that a substantial portion of that time was spent on the ultimately value-negative exercise of attempting to recover debt, he allowed remuneration of $36,000 - being 20% of the assets realised and 72% of that claimed by the liquidators. His Honour continued this same approach in other decisions that followed, causing much concern to insolvency practitioners across the country that they would not be remunerated for work properly undertaken.[44]

Only a few weeks ago, however, the New South Wales Court of Appeal has considered the issue, on an appeal from a decision by Brereton J in *Sanderson as Liquidator of Sakr Nominees Pty Ltd (in liquidation) v Sakr*.[45] The company in liquidation was a "small family company" and its only significant asset was real property, which had been realised by the liquidator for $3.72 million. The creditors of the company had approved the liquidator's fees for the period up to 3 November 2014. The liquidator had sought, *inter alia*,

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[43] Ibid [45].
[44] *In the matter of Gramarkerr Pty Ltd (No 2)* [2014] NSWSC 1405; *Hellion Protection Pty Ltd (In liq)* [2014] NSWSC 1299; see by contrast, Black J in *In the matter of Idyllic Solutions Pty Ltd as trustee for Super Save Superannuation Fund and others* [2016] NSWSC 1292.
[45] [2017] NSWSCA 38.

the determination of additional fees for work undertaken after that date and future work that was required to be undertaken. The total remuneration claimed, including GST was $63,577.80.

At first instance, in determining the additional remuneration at $20,000, Brereton J had held that liquidators would not necessarily be permitted to be remunerated at their firm's standard hourly rates, particularly in smaller liquidations. He observed that in smaller liquidations, questions of proportionality, value and risk loomed large and that liquidators could not be expected to be rewarded for their time at the same hourly rate as would be justifiable if more property was available.

The Court of Appeal allowed the appeal against Brereton J's decision, and referred it back for redetermination. Critically, they held that adopting an *ad valorem* method to assessing remuneration, without regard to the particular work required in the administration is not an appropriate approach. In doing so, they observed that the then s 473 of the *Corporations Act* 2001 (Cth) did not provide for a particular method of calculation but refers to remuneration by "percentage or otherwise" and that proportionality between the size of the property available in the insolvency and the remuneration claimed may be an objective measure of testing the reasonableness of remuneration, but it is not determinative. Finally, they noted that the mere fact that work performed did not result in a net increase to the funds available for distribution does not necessarily mean that the liquidator is not entitled to be remunerated for it; and that there is no requirement of a separate approach to be applied to smaller liquidations. The approach of the Court of Appeal appears to be a sensible one, in circumstances where liquidators perform an important function, but may not necessarily improve the position of the creditors, with the benefit of hindsight.

Although many may have breathed a sigh of relief following the Court of Appeal's decision, critically, the Court did not consider the new provisions of the ILRA and so, in theory, how these will affect the courts' consideration of liquidator's remuneration remains to be seen.

Reforms to Liquidator's Remuneration - Provisions of the ILRA

On that note, it is apparent from the Explanatory Memorandum to the Insolvency Law Reform Bill that the legislature has taken a similar view to Brereton J. The Explanatory Memorandum sets out a concern with the level *and method* of practitioner remuneration, and in particular, the "proportionality of time-based charging" to assets available in the liquidation as a matter of concern; the disproportionate number of complaints arising re: remuneration of insolvency practitioners; the market failures in relation to setting remuneration because the scope of work is uncertain at outset of the liquidation, which is when you might reasonably expect to have negotiations as to fee arrangements; and the incentives created by time-based costing.[46]

There are a number of mechanisms in the Act which are intended to be responsive to these concerns and to provide greater oversight and control over liquidator remuneration.

First, the Act sets out a structure of remuneration determinations, including that the liquidator is entitled to reasonable remuneration for "necessary work properly performed".[47] It also sets out a maximum default amount of $5,000 an appointment which commenced during the financial year beginning on 1 July 2016 (or for following years, the amount when $5,000 is multiplied by the indexation factor the financial year as calculated in s 60-15 or a prescribed amount, whichever is greater). The effect is that, without a remuneration determination, the most that a liquidator can be remunerated is $5000. Equally, it means that in low asset or asset-less windings up, there is no need for a creditors' meeting or Court order to approve this remuneration.

Second of note, subsections 60-10(3) and (4) are important in the context of the time-based costing debate. They provide for a mandatory cap to be set as to the amount of remuneration which can be claimed by a liquidator on a time-based costing method. They also provide for the remuneration determination to specify not only the amount of remuneration, but the method for working out the remuneration as well.

Third and of particular importance, is that the Court may make orders "as it thinks fit in relation to the external administration of a company".[48] While this is not all that dissimilar to the earlier position, there is more detail provided in the new provision including, for example, that this power extends to "an order in relation to remuneration, including an order requiring a person to repay to a company, or the creditor s of company, remuneration paid to the person as external administrator of the company". In making such an order, the Court is entitled to have regard to the following:

(a) whether the liquidator has faithfully performed, or is faithfully performing the liquidator's duties;
(b) whether an action or failure to act by the liquidator is in compliance with an order of the Court, or with the Act and the Insolvency Practice Rules;
(c) whether the company or any other person has suffered, or is likely to suffer, loss or damage because of an action or failure to act by the liquidator; and
(d) the seriousness of the consequences of any action or failure to act by the liquidator, including the effect of that action or failure to act on public confidence in registered liquidators as a group.

[46] See e.g. Explanatory Memorandum, [9.48] onwards.
[47] See e.g. ARITA Code of Practice, Principle 10.
[48] See e.g. Corporations Schedule, s 90-15.

Failure to comply with an order to repay remuneration can have serious consequences for a liquidator. For example, ASIC may suspend[49] or cancel[50] his or her registration, or deliver a "show-cause notice" as to why the liquidator should continue to be registered.[51]

Finally, and importantly, creditors have power under the post-ILRA regime to appoint a registered liquidator to carry out a review into the remuneration of the external administration of the company, and/or a cost or expense incurred by the external administrator of the company. This, combined with their new powers to obtain information as above, gives significantly more oversight to creditors in assessing the reasonableness of the remuneration claimed by liquidators. Importantly, these provisions apply to existing external administrations and remuneration which remains payable, and costs or expenses which were incurred before the commencement of the ILRA.[52]

Conclusion

Interestingly, this is not the end of the road for insolvency reforms in the near future. Jane Prentice MP recognised that "more detailed reform is to come".[53] There has been some indication as to what those changes might be,[54] although at this stage we await further detail as to the precise content and timing of those amendments.

Whether these further changes, or the existing reforms discussed above in this paper, will in fact improve public confidence in the insolvency regime remains to be seen. Although the Explanatory Memorandum repeatedly emphasised that "public confidence in the insolvency profession has not recovered" since the 2010 Senate Report,[55] the basis for this assertion, or that there was a lack of public confidence before the 2010 Senate Report, is not in fact clearly set out. Therefore, the author predicts some difficulty in assessing, going forward, the real impact that these reforms will have on their stated intended target. While there is no question that many of the reforms are welcome, and perhaps overdue, it is hoped that the broad goal of ensuring public confidence will not be used too frequently in this space without careful attention to the means and the method by which confidence will be achieved and measured.

[49] Corporations Schedule, s 40-25(d).
[50] Ibid, s 40-30(d).
[51] Ibid, s 40-40.
[52] *Insolvency Law Reform Act* 2016 (Cth) s 1619(3).
[53]Commonwealth, *Parliamentary Debates*, House of Representatives, 10 February 2016, p1182 (Jane Prentice MP). echoed in the sentiments of Kelly O'Dwyer MP, Minister for Small Business and Assistant Treasurer) on the same day.
[54] See e.g. National Innovation and Science Agenda, "Improving bankruptcy and insolvency laws: Proposals Paper" (April 2016).
[55] See Explanatory Memorandum [2.4], [2.5] and [5.4].