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The Application and Improvement of Australian Insolvent Trading Regime

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Abstract: According to the relevant provisions of the Corporations Act 2001, it can be concluded that Australia takes a type of "conservative" attitude to insolvent businesses. In other words, the law discourages directors from taking any actions that may create new debts for the company in the event of insolvency. The purpose of this regime is to make sure the legitimate interests of the creditors are protected to the maximum extent, and the specific approach is to restrict the various actions of the debtors, thereby avoiding the debtors` continuous obstruction of the realization of the claims. It should be admitted that this system could secure the interests of the creditors from a series possible infringement by debtors. However, at the same time, this regulation also has some corresponding defaults. On the one hand, the content of this regulation is not flexible enough for the balance between legal rights and obligations; on the other hand, this regime itself completely restricts the ability of the directors, as well as the companies (especially the SMEs as the debtor) to operate during insolvency, which is inconsistent with the reality in Australia. Moreover, the current provisions are not conductive to the realization of the creditors` interests. Therefore, based on the above issues, this essay compares Australia`s insolvent trading provisions with the relevant regulations of other countries, and concludes that in order to improve the Australia`s insolvent trading regime, it is worthwhile to refer to New Zealand`s "Reckless Trading" provisions and Canada`s "Oppression Remedy" system.

Keywords: Insolvency Law; Insolvent Trading; Reckless Trading; Oppression Remedy

1. Introduction

The essence of the provisions about the insolvent trading in Australia is to specify one of the fundamental obligations that the directors need to comply with, which is: for bankrupt companies, directors have the responsibility to ensure that the companies will not incur new debts during the insolvency period. The purpose of establishing these provisions is, on the one hand, to ensure that the existing claims that still need to be fulfilled are not interfered by "potential" debts, thereby safeguarding the legal interests of creditors; on the other hand, such regulations can also confirm that the companies (debtors) that have already become insolvent will not fall into the "dilemma" with more debts, thus ensuring the insolvent companies have a greater chance of rallying as soon as possible. It can be seen that the expected effect of establishing relevant regulations and restrictions on insolvent trading is plausible. However, such provisions are no longer in line with the actual situation in Australia.

First of all, the regulations on Corporations Act 2001 only elaborate the detailed adverse consequences (such as pecuniary penalty, disqualification from being a director, criminal liability under some circumstances and so on) that the directors must bear if their actions result in the companies having to incur new debt. But a crucial default of the current regulations is the lack of sufficient flexibility. More specifically, in terms of limiting the actions of the directors, the provisions merely prevent directors from allowing their companies to incur new debts. Nevertheless, the existence of such requirement is actually equivalent to limiting the capacity of insolvent enterprises to continue to engage in various business activities to a giant extent. Because in the process of a company`s normal business, to obtain profits, the company may have to temporarily take on some reasonable debts. But the Australia`s current provisions on insolvent trading do not encourage the directors to make such attempts on behalf of the companies. In other words, the current regime about insolvent trading makes the directors extremely conservative when coping with bankruptcy. More specifically, they may tend not to take any substantial actions to manage the companies except for repaying debts with the companies` assets, because once the behavior of a director is confirmed as a “insolvent trading”, then they will become personally liable for the new debts that are incurred by the companies. This situation is a negative effect of the current insolvent trading regulations. More directly, these clauses restrict the enthusiasm of the directors acting on behalf of the companies (debtors), thereby hindering the smooth fulfillment of the creditors` claims to a certain extent.

Moreover, regarding the topic of whether the insolvent enterprises can continue to operate, Australia has given a corresponding response in 2020. The specific situation is Australia published the Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 (hereinafter referred to as “Corporations Amendment 2020”) at that time, and it has already clearly stipulated that for the SMEs meet the relevant conditions (such as with liabilities of less than $ 1 million), during the restructuring process, the company directors “retain control” of the company`s business, property and affairs, rather than just let the administrator take over the control of the enterprise. The aim of this regulation, as the former treasurer of Australia, Josh Frydenberg said, is to correct the rigid one-size-fits-all “creditor in possession” model to a more flexible “debtor in possession” model. However, at present, the insolvent trading regulations in Australia do not permit the debtors to conduct the so-called “sufficient” management. And according to the provisions of the Corporations Amendment 2020, as long as authorizing the directors to represent the company to keep conducting some business activities and affairs, as mentioned above, the new debts are inevitable under some circumstances. Therefore, a “disharmony” actually exists between the regulations about insolvent trading on Corporations Act 2001 and the relevant provisions on Corporations Amendment 2020. The primary focus is on whether the directors of insolvent companies should be given adequate freedom at the statutory level.

In summary, to better adapt to the actual situation, it is necessary to revise the current insolvent trading provisions in Australia with the reference to the similar regulations of other countries. And the key point of the “revision” is to improve the flexibility and breadth of the relevant insolvent trading regime, making it fit for the ongoing corporate insolvency system reform, and giving directors of insolvent SMEs certain rights and freedom in terms of dealing with bankruptcy. To prove this conclusion, this essay will demonstrate the analysis from three perspectives, the general structure is as follows. The first part will analyze the “fundamental theories”. This part will discuss the rationale of the “insolvent trading regime” by combining the current theories and doctrines of bankruptcy, then explaining the reason why the current insolvent trading provisions in Australia have become rigid at the theoretical level.

The second part will discuss the “existing problems”. This part will compare the application of the insolvent trading provisions in Australia with the application of similar regulations in New Zealand and Canada, with the purpose of explaining the connections and distinctions between Australia`s insolvent trading provisions and the regulations of the other two countries, so as to prove the necessity of Australia`s clauses about insolvent trading to refer to the regulations on New Zealand and Canada.

The third part will mainly talk about the “possible solutions”. The aim of this part is to display the general legislative direction and relevant measures that Australia can choose to improve the insolvent trading regulations, as well as analyzing the possible positive impact on the reform of Australia`s corporate insolvency system after reasonably referring to relevant regulations on New Zealand and Canada.

2. Fundamental Theories

The fundamental theory related to this essay is actually the basic rationale of the insolvent trading. More specifically, it can be divided into the operating principle of the insolvent trading provisions on conceptual level and the effects that these provisions are theoretically intended to achieve. In order to explore the above mentioned, it is important to consider it (the rationale) from a more fundamental theoretical perspective, which is the essence and the purpose of the bankruptcy system itself. Because the insolvency trading provisions, no matter how these terms regulate, the bankruptcy system is their cornerstone. The identification and regulation of the insolvent trading also serve the bankruptcy regime itself. After analysis, the author believes that Australia`s current insolvent trading provisions are more consistent with the bankruptcy theory proposed by Thomas Jackson than other doctrines. The core opinion of Jackson`s theory is that "the bankruptcy should not create rights, instead it should act to ensure that the rights that exist are vindicated to the extent possible." This theory requires a relatively "cautious" and "passive" attitude towards claims when coping with the bankruptcy. More directly, Jackson focuses son safeguarding the legal interests of the creditors, and the specific approach is to discourage all parties involved in a bankruptcy (including creditors, debtors, liquidators and so on, especially the debtors who bear the most compulsory obligations) from taking unnecessary or reckless actions, thereby fulfilling the debts through various measures (such as restructuring, liquidation or the mediation between creditors and debtors) on the existing basis. (The basis mentioned here includes not only a series of "abstract" rights and obligations that already exist, but also the existing "concrete" asset of a specific insolvent company that can be used to repay debts.) This theory is fully reflected in the Australia`s insolvent trading provisions. Because according to the current provisions, insolvent trading is basically prohibited in Australia, and the purpose is to protect the "existing" claims from being influenced by "uncertain" debts in a cautious way. It must be admitted that the insolvent trading needs to be block in some cases, such as the directors` conduct may constitute fraud, because at this time, the directors` actions have clearly brought a predictable significant risk to the performance of the debts. Nevertheless, the author insists that Jackson`s doctrine, as well as the insolvency trading regulations that accord with it, are no longer suitable for the current situation in Australia.

The basis of the author`s judgment is the current system is too absolute to cover the actual situations of all insolvent enterprises in today`s society. More specifically, referring to the view from Elizabeth Warren (which the author agrees with), the bankruptcy system usually does not involve, and should not be dominated by any specific values, regardless of they are biased towards creditors or debtors; the main issue of bankruptcy is how to reasonably "distribute the losses" between creditors and debtors, so as to achieve a result acceptable to all parties. In the process of "distribution", although measures need to be taken to safeguard the existing rights (claims) as much as possible, but the whole procedure is not achieved only by "not creating any right". On the contrary, new rights and obligations will automatically arise when creditors and debtors jointly deal with bankruptcy matters many times. For example, in Re Dessco Pty Ltd, the judge finally concluded that comparing with the liquidation that the plaintiff applied, allowing the restructuring process of the company involved (Dessco in this case) would be more in the interests of the creditors. What is more, for the insolvent company in this case, continuing the restructuring plan means that it needs to retain its control of its property, affairs and business with the assistance of a small business restructuring practitioner. One thing that is important to note is that maintaining the business as usual is equivalent to the possibility of generating completely new rights and obligations at any time, then bringing additional debt subsequently. It should be noted that at this time, this kind of "debt" is inseparable from the affairs and business of the insolvent company. If the directors are permitted to successfully accomplish these transactions, it will be helpful to the implementation of the restructuring plan, thereby having a positive on the fulfillment of the debts. (More directly, the completion of such businesses may offer the opportunity to increase the debtor`s assets that can be used to repay creditors.) In other words, if these normal affairs are identified as "insolvent trading" under this situation, it will undoubtedly bring potential pressure to the insolvent company and the directors, then creating unnecessary obstacles to the restructuring plan.

In summary, through the analysis of the fundamental theories, it can be concluded that the current insolvency trading provisions in

Australia have become rigid because they cannot adapt to the actual situation faced by some bankrupt companies, especially SMEs. The specific situation is that these clauses are confined to the abstract “claims and debts” themselves and ignores the capability and indispensable motivation of SMEs in the real society to resolve insolvency matters, which means that the relevant regulations need to be improved with scientific reference to the regime of other countries.

3. Existing problems - Compare and Contrast

3.1. New Zealand Provisions - Reckless Trading

New Zealand has provisions about “insolvent trading” that are similar to those in Australia, known as “reckless trading” and described in the Companies Act 1993 of this country. Specifically, New Zealand requires that the director of a company must not agree, allow or cause the business of the company to be carried on in a manner that has the possibility of creating substantial risks of serious loss to the companies` directors, which seems to be basically the same as the regulations in Australia. However, New Zealand provides an “exception” in their law, which is directors may agree to the company to undertake the new obligation (including debt) as long as they have grounds that are reasonable enough to believe that the company will have the adequate capacity to perform these “new” obligations when required. By combining these two provisions, a conclusion can be found that in terms of “insolvent trading”, there are significant differences between New Zealand and Australia. The key point is that New Zealand grants a due “exemption” (the “exception” mentioned above) for “insolvent trading”, while Australia does not. By comparing the regulations of these two countries, it can be confirmed that the core issue lies in the judgment of the “retroactivity” of the insolvent trading. Australia has a blanket ban on any affair that saddles insolvent companies with new debt. Nevertheless, New Zealand only blocks the businesses that are truly “irrational or reckless”. More directly, New Zealand is more concerned with the situation faced by directors of the insolvent companies “at the time” of carrying on businesses. In other words, New Zealand regulations require the court to make a case-by-case analysis when judging the conduct of directors. The court`s duty should be examining the reasonableness of the business decisions made by the directors at the time from “their perspective”; rather than simply evaluating the correctness of these decisions and the impact on the insolvent company and creditors in hindsight. According to New Zealand`s logic, when the “reasonableness” of the directors` judgments indeed exist, the court (and legal provisions) should give the debtors the fundamental freedom to conduct business to save them from bankruptcy. The author insists that the regulations in New Zealand are more appropriate than Australia`s provisions. Because the legal terms in Australia are too absolute and actually “eliminate” the debtors` rights to self-rescue, while New Zealand`s law reasonably distinguishes the “insolvent trading”, prohibiting “reckless” ones and exempting “rational” ones. (Note: Permitting “rational” insolvent trading at the time does not mean exempting directors from personal liability afterwards.)

3.2. Canadian Regime- Oppression Remedy

Unlike Australia (or New Zealand), Canada has a unique legal system for directors to impose additional debts on insolvent company, which is summarized as “oppression remedy” in Canada Business Corporations Act (hereinafter referred to as “CBCA”.). The specific content is an authorization to relevant stakeholders, which is as long as the company (or its affiliates) has caused a certain result due to its action or omission, or the power of its directors (and company`s affairs) is or has led to the appearance of the “oppressive behavior that infringes on legitimate interests”, then the stakeholders can apply to the court and request the court to order the correction of relevant matters; thereby achieving the effect of remedying the damaged rights. The reason why the author believes that Australia needs to refer to this regime is that compared with other states (especially Australia), such provisions in Canada provides the “broadest” and the most “flexible” protection for the interests of almost all parties in the common law field.

On the one hand, in terms of “broadness”, the Australian provisions mainly emphasize the restriction of debtor`s rights, while the

Canadian regulations can consider the requirements of almost all parties (including the debtor). More importantly, Canadian regime is not just stuck in the abstract legal identities of “creditor” or “debtor” but pay more attention to the specific “person” that exists in judicial practice. More specifically, oppressive remedy establishes no restrictions on the “stakeholders” who may apply. Creditors, debtors, directors, as well as the officers all have equal rights on the “oppression remedy”. On the qualifications of the creditors, it is needless to say; however, one point worth noting about other parties is that the recognition of the qualifications of directors and officers is a groundbreaking measure, which to some extent is equivalent to a further classification of the “debtor”. Because although an insolvent company is a “debtor” as a whole, it is composed of many specific people, usually including employees and more than one director. If the action of “a director” is determined to be “oppressive behavior”, or “insolvent trading” in Australia, then this decision will not only infringe the rights of creditors, but also the legitimate interests of other members of the company (such as other directors). The law has the obligation to guarantee the interest of these “innocent debtors”. And Canadian “oppression remedy” does take this practical situation into consideration.

On the other hand, regarding the flexibility, oppression remedy also requires the court to not only focus on the legal provisions, but also to reasonably judge and apply terms according to the specific circumstances of the case. (Because the scope of the “oppression” is extremely board, if only concentrating on the literal clauses, no substantive conclusion can be drawn.) A typical example is that in Wilson v. Alharayeri, the judge made an accurate judgment, which is the court is instructed to engage in fact-specific enquiries, so that the court needs to be looking at “business realities, not merely narrow legalities.” What is more, the judge also determines that the purpose of this regime is to ensure fairness, which should be the aim of all laws.

In summary, both New Zealand`s “reckless trading” and Canada`s “oppression remedy” are valuable to the reference of Australia`s insolvent trading provisions. Specifically, New Zealand`s provisions give debtors fundamental rights at macro level, thereby achieving a “balance” at the legal level, while Canada`s regulations focus on actual situations and have sufficient flexibility and applicability in specific cases.

4. Possible Solutions

According to the “existing problems” mentioned above, the possible solutions, more directly, the direction of improving Australia`s insolvent trading provisions can be considered from the following two perspectives.

4.1. Regarding the Reckless Trading Regime

First of all, as pointed out before, Australia has a near-total ban on insolvent trading, and the purpose of such “limitation”, as the judge concluded in Woodgate v Davis, is to “engender in directors of companies experiencing financial stress a proper sense of attentiveness and responsible conduct directed towards the avoidance of any increase in the company`s debt burden.” However, for the time being, the above goal cannot be achieved. Firstly, depriving enterprises (mainly SMEs) of the capacity to continue their affairs is inconsistent with the Australia`s reforms to the corporate insolvency system that the essay mentioned earlier. Moreover, according to the statistics from ASIC (Australian Securities & Investments Commission), the vast majority of companies entering external administration have continued to trade and incur debts for months despite being insolvent. In light of these facts, the author argues that rather than insisting on existing provisions that are no longer feasible, it would be more appropriate to refer to New Zealand`s reckless trading regime and reasonably remove the threshold of “insolvent trading” sometimes. The specific requirement is that when the directors indeed have the adequate reasons to believe, based on their own circumstances, that such “insolvent trading” will not expose the company to a greater debt pressure and has a substantial possibility of fulfilling existing debts more smoothly, then the law can permit such “trading”. This correction is necessary because the current rules (in Australia), although limiting the possibility for the debts to increase, they also eliminate the opportunity for insolvent companies to increase their assets. As AICM (Australian Institute of Credit Management) points out, the current regime makes the creditors can generally expect little to no return from the insolvency, and New Zealand`s "reckless trading" provisions give directors the chance to continue "rational" insolvent trading, which also give the creditors the "hope" to obtain more "returns". However, it should be noted that the reckless trading provisions only allow directors to conduct the insolvent trading based on rationality, but if these transactions still lead to the company`s increased debt burden, the personal liability of the directors cannot be exempted simply because the directors say that "the trading is not reckless". Such regulation is to prevent directors from abusing insolvent trading to infringe the interests of creditors and other members in the insolvent company.

4.2. Regarding the Oppression Remedy Regime

Australia should also refer to Canada`s "oppression remedy" provisions. Because the "reckless trading" in New Zealand only determines that directors can enjoy fundamental freedom in "insolvent trading". However, in judicial practice, there are still no corresponding clauses to safeguard the "freedom" of directors, nor are there terms to instruct other parties (such as the creditors) on how to respond to the "insolvent trading" made by directors. Canada`s oppression remedy covers the above practical issues extensively. This regime requires that if the behavior of directors (including insolvent trading, of course) is oppressive and violates the interests of other parties, then they can apply to the court to correct or invalidate such behavior. This system can make the "reckless trading" regulations truly flexible in specific cases, giving all parties involved (including the court) enough space to make concrete analysis according to specific situations. In addition, for oppression remedy, there is a point that ought to be noticed, which is the "parties" who can apply, as mentioned earlier, should not only include the creditors, but also debtors (other members of the insolvent company, such as other directors and employees), because although the purpose of "insolvent trading provisions" is to ensure the creditors` claims, the subjects whose legitimate interests may be affected by "claims" are not just creditors. This point is emphasized due to the need to balance the rights of all parties participated in the insolvency.

5. Conclusion

To sum up, Australia`s current insolvent trading provisions are too absolute and rigid. Therefore, it is necessary to reasonably refer to New Zealand`s "reckless trading" regulations and Canada`s "oppression remedy" system. The "reckless trading" terms balance the interests between creditors and debtors (insolvent company and its directors) in theoretical level. Accordingly, the "oppression remedy" regime makes the "balance" adequately flexible and applicable in judicial practice, so as to take into account the legitimate rights of all parties while dealing with bankruptcy.

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