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A Green Light for Corporate Theft

The substantial weakening of corporate insolvency protections announced by the Federal Government effectively gives companies a green light to steal from their employees, trade creditors and taxpayers. The vested interests of legal practitioners and company directors have again won the argument, with their payments and interests being prioritised over employees and suppliers. Employees and suppliers can no longer operate with confidence that their provision of goods and services will be paid for, with the most meaningful protections of their legal right to be paid having been stripped away.

To understand why the changes are so awful it helps to step back and review the foundations of corporate activity. Setting up a company allows individuals to separate their personal financial position from their business interests. However, without adequate safeguards setting up a corporation would be an opportunity for individuals to steal from employees, suppliers, financiers and taxpayers. If there is no personal liability attached to directors of companies for failing to pay creditors, there is little to discourage a business from continuing to acquire goods and services that it knows it won't be able to pay for in a reasonable period.

Personal liability for insolvent trading is the bedrock of a general assumption that a company is solvent unless it says otherwise. The assumption of solvency underpins an employee providing their time and skills, and suppliers providing their goods and services. The removal of this assumption means everyone supplying a business should assume that the business is not solvent until proven otherwise and that they should conduct their own detailed financial checks on the business before engaging with them. The most practical response is to shift to payment on delivery.

A second major protection for employees, suppliers, financiers and the ATO is the right to apply for a business to be wound up if they refuse to pay their debts. Without this protection, businesses can run up debts with an ever growing list of unpaid creditors. When an employee or supplier stops supplying good and services as they have not received payment, they are replaced with another hapless creditor. Ordinarily, this cycle stops when one of the creditors issues a statutory demand that is not responded to, followed by a court order for the company to be wound up.

The changes announced by the Federal Government this week dispense with or substantially defer creditor's rights to rely on these protections. Companies now have six months instead of 21 days to respond to a creditor's statutory demand for payment. Director's liabilities for insolvent trading have been suspended for six months. The combined effect of these changes is that companies can effectively steal from their creditors and are very unlikely to ever be held responsible.

Whilst the Government's fact sheet claims that "egregious cases of dishonesty and fraud will still be subject to criminal penalties", there is almost no prospect of this being enforced. The corporate regulator, ASIC, receives thousands of documented cases of insolvent trading each year and prosecutes a mere handful. It will soon be overrun with cases of alleged insolvent trading and directors failing to uphold their statutory duties and will prosecute almost no one. For the handful of prosecutions that do proceed, there is little prospect that the process will result in unpaid creditors being made whole.

Particularly galling is the lobbying by legal practitioners and company directors for these changes. Restructuring advice is a lucrative revenue stream for lawyers. Allowing large corporates that are of questionable solvency to continue to trade and seek further legal advice is in their financial interest. However, lawyers expect to be treated differently from other suppliers, they often demand payment in advance when they are providing advice to companies of questionable solvency. Whilst these fees could theoretically be clawed back as preference payments, it rarely occurs.

Similarly, company directors have a financial interest in prolonging the life of a company so they can continue to be paid their director's fees. Typically, they are also shareholders, so if a miracle solution can be found they will also benefit through a share price recovery. What they always fail to mention is that they want to be allowed to gamble with creditor's funds (e.g. unpaid wages, invoices, loans and taxes) when they are unwilling to put up their own capital to stabilise the company. It's a classic "heads I win, tails you lose" scenario.

Eliminating the personal liability of directors reverses the onus of financial responsibility. Directors and senior management are the people best placed to decide whether a company is solvent and to take action to rectify the financial position. It is perfectly logical that those most informed and able to impact the financial position of the company bear responsibility for paying creditors. By eliminating personal liability, potential employees and trade creditors are expected to become skilled financiers overnight, determining which companies are likely to pay them before they supply goods and services.

The practical implication of these changes is that a wave of unpaid obligations will build up in the economy. Companies that otherwise would have appointed administrators are now free to continue to accrue debts without any likely consequence. As a result, employees and solvent businesses will take greater losses when poorly managed companies fail to pay them. If the existing system had remained, business failures would have been contained to predominantly poorly managed and poorly capitalised businesses rather than spreading further. Well managed and well capitalised businesses would have entered these difficult economic times with meaningful reserves, thus allowing them time to cut their costs to the bare minimum and survive a temporary shutdown.

This is where basic economics kicks in. Businesses that were barely profitable and had no reserves should be the first to fall. For the good of the wider economy, these businesses (assuming they cannot raise additional capital) should close immediately without incurring additional debts. Once the shutdown ends, if there is demand for the goods and services they were providing another business will take their place. Stood down employees will find work with these new or enlarged businesses. The alternative (which the government changes encourage) is to allow the weakest business to accrue greater liabilities and spread their losses across a larger number of people and businesses when they eventually fail. There is no free lunch, only a choice between who takes the loss and how great the loss is.

The inability of politicians to recognise the inevitable outcomes shows a lack of moral values and basic policy development. During the insolvency reform consultations in 2016 and 2017, I made two submissions detailing the obvious flaws in arguments from lawyers and company directors for weakening insolvency protections. Despite the clear evidence against their position, the politicians and public servants involved repeatedly refused to discuss the issues. Instead, they pressed ahead with changes that gave greater scope for companies to steal from their creditors. The current crisis has been an opportunity for lawyers and company directors to get what they always wanted; a greatly increased ability for poorly capitalised and poorly managed businesses to engage in theft without meaningful consequences, whilst their well fed snouts remain in the trough.

Written by Jonathan Rochford for Narrow Road Capital on 28 March 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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