Ferrier Hodgson

Level 13, Grosvenor Place
225 George Street
Sydney NSW 2000
GPO Box 4114
Sydney NSW 2001

T +61 2 9286 9999
F +61 2 9286 9888
E sydney@fh.com.au
www.ferrierhodgson.com

8 March 2013

Corporate Governance and Reporting Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES NSW 2600

by email: insolvency@treasury.gov.au

Att: Manager

Dear Sir/Madam

Insolvency Law Reform Bill 2013

Ferrier Hodgson was established offering formal insolvency services in Melbourne and Sydney in 1976. In the 37 years since, it has expanded that service line to include Corporate Recovery, Forensics and Corporate Advisory. The firm now has offices in Brisbane, Adelaide, Perth, Singapore, Tokyo and Kuala Lumpur. Ferrier Hodgson also has representation in Hong Kong, China, Europe and the Americas through affiliations with Zolfo Cooper (UK, US, Caribbean), KLC Kennic Lui (HK, China), Eight Advisory (France, UK) and ThierhoffMuller (Germany).

In Australia, 28 Partners and more than 300 staff are involved daily in formal insolvency work and are concerned to ensure that the legal framework is efficient and unambiguous.

Please find here our comments on the exposure draft for your consideration.

I note we have provided comments on the following sections of the bill:

- Remuneration
- Funds handling
- Information
- Meetings
- Committees of inspection
- Reviews

Section of bill	Comments
Remuneration	
22-20 Review of remuneration determinations	• While the majority of this section appears appropriate, I note there is no time limit on calling for a review of remuneration. A time limit should be included. We suggest either 20 business days or 28 days after the remuneration claim notice is issued.
22-30 Default remuneration amount	• We support the introduction of a minimum entitlement in order to streamline the remuneration process. • While the default remuneration amount of $5,500 seems appropriate, the bill should specify if the amount is inclusive or exclusive of GST. • I note that indexation is used for the bankruptcy system and this could also be appropriate for external administrators to further increase harmonisation.
22-35 Trustee ("T") / External Administrator ("EA") must disclose employment etc. of related entities	• The current wording of the draft bill seems to indicate that an external administrator will be required to prepare a disclosure themselves before using their staff on any engagement that they take. In the case of practice entities this process is impractical. An exception should be provided for staff members of practice entities.
22-45 T / EA must not accept extra benefits etc.	• For the sake of clarity, extra benefit should be defined so as to exclude any indemnity provided.
22-50 T / EA must not give up remuneration	• Further explanation and detail is required around what is meant by "give up" remuneration and why this section is required. The bill should specifically clarify how it relates to forgoing or transferring remuneration, or if it relates to the need to remove a circumstance whereby an incentive or commission is provided to a referrer of work.
22-65 Division of remuneration and expenses	• To further harmonise the bill, additional sections applicable for T could also be included for EA.
22-70 Account of receipts and payments	• It seems unreasonable that the former trustee should go through the process of providing accounts to each creditor, particularly if they are providing the information to the new trustee, therefore 22-70 (1) (c) should be removed.
	• Further to the above, we would make a general comment about the need for clarity within the bill on priority of remuneration in the case where a T or EA is replaced. We would suggest that the rules for an EA are harmonised with rules for a T and the incumbent in this circumstance should receive priority for remuneration which is already approved at the time of the replacement.

Section of bill	Comments
Funds handling	
24-10 Paying money into / Opening, and paying money into, administration account	• An EA should only be required to open a bank account if there are funds, otherwise they will incur unnecessary time costs and bank fees. • Given banking can be difficult around certain times of the year and banks trade less than normal business days, perhaps 10 business days, rather than five, would be more appropriate
24-15 Consequences for failure to pay money into administration account	• A criminal penalty seems extreme and should be excused for circumstances other than intentional criminal negligence.
24-40 Handling of securities	• A criminal penalty seems extreme and should be excused for circumstances other than intentional criminal negligence.
Information	
26-10 Annual administration return	• It is impractical and inefficient for insolvency firms to be required to complete an annual return for all of their administrations within the same 25 day window. Should a firm be appointed to a new and large administration during or before this time it would become an impossible task. However even if that was not the case, due to the large number of returns which will be required to be lodged all at once, this timeframe is inappropriate. • Should it be decided that all returns are to be lodged for the financial year, the timeframe for lodgement should be extended to at least three months. • Another option could be to establish a system whereby half of all administrations lodge returns at one date and the other half of administrations lodge returns at another time (for example 31 March and 30 September), however there will still be a large number of returns to be lodged at once and therefore one month would still be an inappropriate deadline for lodgement.
26-15 Administration books / Books of external administration	• It is impractical to expect that external administrators are able to keep all of the books and records for administrations at their offices. Storing books and records off-site is a necessity. • Costs will invariably be involved in arranging the inspection of books by a creditor or contributory and the creditor or contributory who requests to inspect books and records should do so that their own cost, rather than the cost of other creditors. • "At all reasonable times" should be defined.

Section of bill	Comments
26-40 Transfer of books to new T / EA	• Former administrators are required to complete returns and other tasks requiring the books and records for greater than five days in many instances, and copying all of the required information can be a costly and time consuming exercise in itself, and there would possibly be no funds available to cover those costs. • A possible solution would be that the former administrator must provide to the new administrator all books not required for any returns or finalisation tasks, and must make other information available on a reasonable basis until all finalisations tasks are completed.
26-45 Retention and return or destruction / Retention and destruction of books	• In the EA section, reference to "trustee" should be replaced by "external administrator".
26-65 Commonwealth may request information	• Provisions should be made for the costs of providing this information.
Meetings	
28-15 T must convene meeting if required by creditors / EA must convene meeting in certain circumstances	• We agree with the proposed rules for a T. • Further consideration should be given to the harmonisation of the corporate and bankruptcy provisions. At present it seems that the rules for an EA are more complicated than those for a T, without benefit being added. • Wording should be included giving reference to the "value of claims that are known" by an EA or T at the time of the request for a meeting.
28-40 Creditors' / Creditors' or contributories' resolution without meeting	• This section for an EA could also be further harmonised with the same section for a T and a majority of creditors required for a resolution should be required in value only.
Committees of inspection	
30-10 Committee of inspection / Appointment and membership of committee of inspection – company not in pooled group	• The references to meetings of contributories could be removed. • There could be further explanation of the requirement for creditors to be 10% of all creditors in value, or be supported by 10% of all creditors in value, in order to be members of the COI. • There could also be further explanation around whether the employee representative for the COI needs to prove they represent at least 50% of employees, and if so, how they would do this at a meeting.
30-15 Functions of committee of inspection	• The function of approving remuneration of a T or EA could also be included in the list.

Section of bill	Comments
30-30 Committee of inspection may obtain specialist advice or assistance	• It could be clarified who pays the costs for the advice received by a member of the committee and the approval process for this expense to be incurred.
30-35 Obligations of members of committee of inspection	• Along with the Court, the T or EA should have the power to set aside a transaction entered into in contravention of this section.
Review	
32-15 Court may inquire on application of creditors etc.	• All costs associated with these applications and inquiries by the Court should be paid by the creditor or other party that makes the request, unless it is specifically appropriate for the cost to be paid by the estate or company. • Consideration could be given to whether or not this amendment is required or if current provisions are satisfactory.
32-24 Review	• There should be reasonable time limits set for the appointment of a reviewer.
32-35 Removal by creditors	• As the removal of a reviewer could cause disruption to a T or EA and increase costs of an administration, it may be more appropriate for creditors to apply to the Court in order to remove the reviewer, rather than being able to remove the reviewer with just creditor approval.

As a general comment, I would also note that consideration could be given within the exposure draft to a new issue that is arising in the industry, being the storage of information by information technology companies, also known as keeping information in a "cloud". We would recommend that an amendment be made to include IT professionals with accountants and lawyers as being required to provide company information as required by an administrator. The need for this amendment and a practical example is explained in more detail in the attached postcard.

Should you have any questions in relation to any aspect of the bill or these comments, please do not hesitate to contact me.

Yours faithfully

John Melluish
Partner

Ferrier Hodgson

7 March 2013

CREDIT RISKS OBSCURED BY CLOUD COMPUTING

Cloud computing is a relatively new technology. Its benefits mean that domestic business uptake rates are rapidly increasing and are likely to continue to do so.

The benefits offered by cloud computing are clear. Companies can realise direct cost savings via outsourcing their information management requirements to third-party providers.

Outsourcing means that companies only pay for the IT capacity that they need, gives them access to the latest software, provides the convenience of a professional external backup service and smooths cash flows by avoiding periodic hardware and software upgrade costs.

Whilst the business case may make sense, outsourcing to the cloud can create vulnerabilities to a business, particularly in circumstances of financial distress. While not immediately obvious as a credit related issue, financiers need to carefully consider the risks this technology may pose to their customers, particularly in a distressed scenario.

This became a real issue in the recent Voluntary Administration of the RPG Group, one of Australia's largest steel fabrication and engineering groups.

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The RPG Group Administration

- Ferrier Hodgson partners, Peter Gothard, Jim Sarantinos and Tim Michael were appointed Voluntary Administrators to the RPG Group in October 2012.
- The majority of RPG's day-to-day activities were supported by software and data storage located in the cloud. These services included everything from standard e-mail and office automation software, to the Group's back office and accounting packages through to the front-end CRM systems, inventory management and production planning software. In short, the majority of the key business records.
- The Group's operations could not operate in any meaningful sense without access to these services.

Issue

- Prior to our appointment, RPG had entered into a three year contract with the cloud provider which incorporated an 'ipso facto' clause allowing all services to be terminated upon an insolvency event, with the Group liable for any damages should back-to-back contracts with the providers be terminated.
- The supplier gave notice that it intended to terminate services immediately. There was no requirement in the contract to return the Group's data upon termination.

- In order to continue the provision of services, the cloud provider demanded:
  - The payment of its pre-Administration liability (some $16,000).
  - That the Administrators pay out the remaining two year term of the contract (some $100,000) upon the Group entering liquidation.
  - An increase in the cost of the service to $1,000 per day (a four times multiple of the original cost).
  - A substantial increase over its normal hourly rate for IT support services.
- RPG had no backup of its data and no backup IT system in place and therefore could not operate without the cloud service.
- The vulnerability RPG had unwittingly created in its business model presented a significant hurdle to both ongoing operations and the Administrators' ability to complete a going concern sale of the business.

Administrators' right to books and records?

- While we would likely have been successful in obtaining a Court order for a copy of the data under section 438C of the Corporations Act 2001 (the Act), this would have taken a number of days. Migration of the data to another provider or the purchase of sufficient hardware to restore the system to working order would have taken significant time and financial resources.
- From a practical perspective, any such delay would have caused the operations to cease and severely jeopardise the going-concern sale process.

Essential service?

- Section 600F of the Act defines an essential service as electricity, gas, water and a carriage service within the meaning of the Telecommunications Act 1997 (broadly telephones and mobile phones) and ensures the continuance of these services following an insolvency event.
- While the provision of IT services are an essential element of modern business operations, no protection is currently provided by the Act.

Learning points for financiers

In this case we were ultimately able to negotiate an acceptable settlement of the issue, thanks in large part to a quirk of the Group's corporate structure and delayed appointment of Administrators to an entity within the Group.

The experience does however highlight a significant risk area, especially for businesses which incorporate expansive and time-critical IT systems (eg: retailers; financial services). This risk is not only relevant to an insolvency situation. A dispute between a company and its cloud computing provider or any disruption to the cloud computing provider's business may leave the company and its bankers exposed.

Specifically, lenders should:

1. Ensure that contractual terms for business-critical services are adequately negotiated up front by customers to ensure that your position is protected. For example, contracts should provide for a limited minimum level of service, access rights to data for a period of time following an insolvency event and the immediate return of company data upon termination of service.
2. Consider business-critical IT systems carefully as part of any due diligence, pre-lend review, independent business review or contingency planning exercise.
3. Require the customer to consider and take steps to adequately mitigate the risks of parting with control of key business data.
4. Ensure that the business retains control of its data backups and that such backups are routinely and properly performed (we have seen other cases where inadequate backup regimes have been in place).
5. Keep in mind that there will be instances where suppliers will introduce 'green mail' tactics both in terms of the recovery of unpaid pre-appointment debts and also committing to new, sometimes onerous, trading terms. If the IT services are of a business critical nature, consideration must be provided to the cost of any settlement especially in larger corporate insolvency matters.

If you would like to discuss how these issues could affect you, please contact one of the below team members directly.

Peter Gothard
Partner
+61 2 9286 9950

James Dampney
Director
+61 2 9286 9967

This article was prepared by members of Ferrier Hodgson's Energy team. They regularly send an *Energy Postcard* detailing the latest news and trends in the sector. If you have any comments or suggestions, please contact Peter Gothard directly at peter.gothard@fh.com.au.

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Ferrier Hodgson

For more information about our services, please contact one of our offices. Or find out more at: **www.ferrierhodgson.com**:

Sydney: Steve Sherman
+61 2 9286 9905
steven.sherman@fh.com.au

Adelaide: Martin Lewis
+61 8 8100 7657
martin.lewis@fh.com.au

Perth: Martin Jones
+61 8 9214 1405
martin.jones@fh.com.au

Malaysia: Andrew Heng
+60 3 2273 6227
aheng@fhmh.com.my

Melbourne: Peter McCluskey
+61 3 9604 5109
peter.mccluskey@fh.com.au

Brisbane: Will Colwell
+61 7 3834 9205
will.colwell@fh.com.au

Japan: Kentaro Mochizuki
+81 3 3560 8301
kmochizuki@fh-tokyo.jp

Singapore: Tim Reid
+65 6416 1400
tim.reid@fh.com.sg