



Australian Government



# Insolvency reforms to support small business

The Government is making changes to our insolvency framework to better serve Australian small businesses, their creditors and their employees. The changes will introduce new processes suitable for small businesses from 1 January 2021, reducing complexity, time and costs for small businesses.

The changes will enable more Australian small businesses to quickly restructure and to survive the economic impact of COVID-19. Where restructure is not possible, businesses will be able to wind up faster, enabling greater returns for creditors and employees.

These reforms are the most significant changes to the Australian insolvency framework in almost 30 years. They form part of the Government's JobMaker plan to ensure Australia emerges from the pandemic with a stronger, more resilient and more competitive economy. The need to give businesses and their creditors certainty is crucial to kick-starting confidence and activity as the economy transitions to the recovery phase.

## Our insolvency system needs reform

An efficient and effective insolvency system is important in generating business dynamism which is needed to underpin our economic recovery. The system helps the movement of capital and jobs to more productive from less productive firms. It allows the efficient winding up of businesses, ensuring creditors and employees are paid fairly.

The insolvency system is facing a number of challenges:

- An increase in the number of businesses in financial distress because of COVID-19.
- A 'one-size-fits-all' system, which imposes the same duties and obligations, regardless of the size and complexity of the administration.
- Barriers of high cost and lengthy processes that can prevent distressed small businesses from engaging with the insolvency system early, reducing their opportunity to restructure and survive.

On 22 March 2020, the Government announced temporary measures to support businesses to get through the Coronavirus outbreak. These measures have had a positive impact on allowing businesses to survive, with a 46 per cent decrease in the number of companies that have gone into external administration over the period from March to July 2020 compared with the same period last year. However, as the temporary relief expires at the end of December, the number of companies being put into external administration is expected to increase significantly, putting additional stress on the system. These reforms will help more businesses to successfully get to the other side of the crisis.

The package of reforms features three key elements:

- A new formal debt restructuring process for small businesses to provide a faster and less complex mechanism for financially distressed but viable firms to restructure their existing debts, maximising the chance of them surviving and contributing to economic and jobs growth.
- A new, simplified liquidation pathway for small businesses to allow faster and lower-cost liquidation, increasing returns for creditors and employees.
- Complementary measures to ensure the insolvency sector can respond effectively both in the short and long term to increased demand and to the needs of small business.

Together, these measures will reposition our insolvency system to reduce access costs for small business, to reduce the time they spend during insolvency processes, to ensure greater economic dynamism, and ultimately help more small businesses to survive.

These measures will commence on 1 January 2021, subject to the passing of legislation.

Small and medium enterprises may warrant a different treatment from other firms in a debt restructuring strategy as complex, lengthy and rigid procedures, as well as required expertise and high costs of insolvency can fail to adequately meet the needs of SMEs

– OECD, *Going for Growth 2018*

## A new restructuring process to enable more small businesses to survive

Many small businesses will have significantly increased their level of debt in order to remain in business during the Coronavirus outbreak. To support small businesses facing financial distress to recover, it will be important that they can access a simple, cheap and faster means to restructure their debt. This will allow more businesses to go on

trading, meaning better outcomes for the businesses, their creditors and their employees.

Currently, requirements around voluntary administration in Australia are more suited to large, complex company insolvencies. The high costs of voluntary administration can also consume most or all of the value of a small business's assets, making it harder for the business to restructure and reducing the business's willingness to engage with the system. Voluntary administration also involves placing the business under the control of an administrator, which may deter many small and family businesses from accessing the process.

A new, simplified restructuring process drawing on key features of the US Chapter 11 bankruptcy process will be introduced for eligible small businesses so that they can restructure their debts, maximising their opportunity for survival. The process will allow small businesses to access a single, streamlined process while allowing the owners to remain in control of their business.

The Productivity Commission reported in 2015 that almost 60 per cent of companies that enter voluntary administration are deregistered within three years. The new restructuring process is not only aimed at enhancing the rate of successful restructuring outcomes, but also providing a pathway for distressed small businesses that historically would never have entered voluntary administration due to the costs and the loss of control associated with that process.

### **Who can access the new restructuring process?**

The process will be available to incorporated businesses with liabilities of less than \$1 million.

Around 76 per cent of companies entering into external administration in 2018-19 had less than \$1 million in liabilities. Of these, around 98 per cent are estimated to be businesses with less than 20 full-time equivalent employees. Larger and more complex businesses, as well as small businesses seeking more flexibility in how they may restructure, can continue to use voluntary administration.

### **A 'debtor in possession' model**

The proposal adopts a 'debtor in possession' model. That means that the business can keep trading under the control of its owners, who know the business best, while a debt restructuring plan is developed and voted on by creditors.

Business owners will be able to trade in the ordinary course of business when a plan is being developed; prior approval of the small business restructuring practitioner (the practitioner) will be required for trading that is outside the ordinary course of business.

The business owners will be required to work with the practitioner to develop and put forward a restructuring plan and to provide information about the business's financial affairs to the practitioner to assist with identifying creditors and to assist creditors in making an informed decision on the restructuring plan.

### **The role of the small business restructuring practitioner**

The new process would streamline the role for, and powers of, the practitioner compared with the role played by an administrator in a voluntary administration. This reflects the reduced complexity of the new process and the businesses eligible to use it.

The practitioner will: help determine if a company is eligible; support the company to develop a plan and review its financial affairs; certify the plan to creditors; and manage disbursements once the plan is in place. A practitioner will not be required to take on personal liability for a company or manage its day to day affairs.

To support more practitioners being available to work with small business, they will be able to choose to register as a small business restructuring practitioner only. Their practice will be limited to the new simplified restructuring process. Qualifications required to register as a small business restructuring practitioner only will be in line with the streamlined requirements of the role. Registered liquidators will also be able to manage the new process.

### **Supporting small businesses to access the new restructuring process**

It will take time for practitioners to become familiar with the new processes and to register as a small business restructuring practitioner. As a result, not all small businesses will be able to access the process immediately on 1 January 2021, after the existing temporary insolvency protections expire on 31 December 2020.

To address this transitional issue, an eligible small business will be able to declare its intention to access the simplified restructuring process to its creditors, including through ASIC's published notices website. Following the declaration, the existing temporary insolvency relief (relief from insolvent trading liability and around responding to statutory demands from creditors) would then apply to the business for a maximum period of 3 months, until they are able to access a small business restructuring practitioner or other insolvency practitioner. Relief would only apply to an individual business once a declaration is made. As a transitional measure, the ability to declare such an intention will be available until 31 March 2021.

### **What protections will be in place to prevent misuse of the new restructuring process?**

Safeguards will be included to prevent the process from being used to facilitate corporate misconduct such as illegal phoenix activity. They include a prohibition on related creditors voting on a restructuring plan, a bar on the same company or directors using the process more than once within a prescribed period (proposed at 7 years), and the provision of a power for the practitioner to stop the process where misconduct is identified.

### **How will creditors rights continue to be protected?**

Key mechanisms will be included as part of the restructuring process to ensure that creditor interests are represented and protected. Importantly:

- The role of the practitioner, who will administer the process, remains independent. The practitioner will have important obligations they must fulfil on behalf of creditors (such as certifying the plan).
- Key creditor rights will be preserved. For example, there are no changes to the rights of secured creditors, and similar types of debts are treated consistently.
- Creditors retain the right to vote on the debtor company's proposed plan and the plan must achieve the requisite majority to be binding.

### How will the new process work?

- A small business facing financial distress approaches a practitioner to discuss their options. The practitioner advises that the new reorganisation process is the most appropriate option in their circumstances, and the owners accept the advice. The practitioner proposes a flat fee for their work in helping the business develop a restructuring plan.
- Following a resolution of the board, the business signs up the practitioner as their small business restructuring practitioner. On commencement, unsecured and some secured creditors are prohibited from taking actions against the company, a personal guarantee cannot be enforced against a director or one of their relatives, and a protection from ipso facto clauses (that allow creditors to terminate contracts because of an insolvency event) apply (with the same protections applying as during voluntary administration).
- The business owner works alongside the practitioner over a 20 business-day period to develop a plan to restructure the business's debts and provide supporting documents for creditor consideration. During this time, the owners continue to control the business and can trade in the ordinary course of business. The practitioner also develops a remuneration proposal to cover their management of the plan once in place, which will operate as a percentage fee of disbursements made under the plan.
- The practitioner sends the plan and supporting documents to creditors and certifies whether they consider the business can meet the proposed repayments and has properly disclosed its affairs. Creditors have 15 business days to vote on the plan, including the proposed remuneration for the practitioner. The business must pay any employee entitlements which are due and payable before a plan can be put to creditors.
- If more than 50 per cent of creditors by value endorse the plan, it is approved and binds all unsecured creditors. Creditors vote as one class. Secured creditors are bound by the plan only to the extent their debt exceeds the realisable value of their security interest. To support the integrity of the process, related-party creditors are not entitled to vote.
- If the plan is approved, the business continues and the practitioner administers the plan by making distributions to creditors according to the terms of the plan. If voted down, the process ends, and the company owners may opt to go into voluntary administration or to use the simplified liquidation pathway proposed in this paper.



Figure 1, at the end of this document, provides a visual overview of the new restructuring process.

## Case study: Terry's swim centre

Terry owns and runs a popular swimming school in Sydney.

During the early stages of the Coronavirus outbreak, patronage at the school drops sharply as people comply with health restrictions. Once the measures were wound back, customers slowly returned.

While income mostly returned to normal, Terry's business faces a financial crunch. Terry had accrued significant debts while his business was in 'hibernation'. These debts are soon due to be paid.

When the temporary insolvency measures are removed in January, Terry worries about the risk that his business is trading while insolvent.

### Without access to the new restructuring process

Terry researches some options for distressed businesses, but is wary of voluntary administration because of its cost. He is also deeply concerned about the prospect of outside administrators taking over the running of his business. He worries that the administrator will choose not to operate the business, because the administrator would be liable for debts incurred and the business has insufficient assets to cover these.

Terry continues to trade for a period. However, the debt burden becomes too great to bear, and he is eventually unable to make payments to his creditors when they come due.

Terry has no choice but to place his business into liquidation. The swimming school closes and its employees are laid off. Its creditors receive a proportion of the debts they were owed.



### With the new restructuring process in place

Terry approaches a practitioner, who advises him to engage in the new restructuring process. Terry, with the support of the practitioner, identifies his creditors and proposes a new repayment schedule through a restructuring plan. The practitioner looks at the business's financial affairs, and determines that the plan is workable. The plan is put to creditors, a majority of whom by value approve the plan.

Terry remains in control of his business throughout the process and is able to continue trading. The debts owed to creditors are paid back according to the terms of the plan. Terry's employees remain employed and his business trades on, contributing to the economic recovery. Although the creditors receive a reduced payment versus the amount they were initially owed, they receive more than if Terry were to put his business into liquidation.

The system as it stands does not work for small businesses

- *Australia Small Business and Family Enterprise Ombudsman, Insolvency Inquiry Report, July 2020*

## A simplified liquidation pathway for small businesses

Regulation around liquidation in Australia, including mandated investigative functions, is suited to large, complex company failure, where intentional misconduct may have been involved. However, most liquidations in Australia relate to small businesses, who overwhelmingly fail 'honestly'. In these cases, the costs of the liquidation can consume all or almost all of the remaining value of a company, leaving little for creditors.

Under the new process, regulatory obligations will be simplified, so that they are commensurate to the asset base, complexity and risk profile of eligible small businesses. This will free up value for creditors and employees, and allow assets to be quickly reallocated elsewhere in the economy, supporting productivity and growth.

The simplified liquidation process will retain the general framework of the existing liquidation process, with modifications to reduce time and cost. As currently occurs, the small business can appoint a liquidator who will take control of the company and realise the company's remaining assets for distribution to creditors. The liquidator will also still investigate and report to creditors about the company's affairs and inquire into the failure of the company.

Time and cost savings will be achieved through reduced investigative requirements, requirements to call meetings, and reporting functions. Key modifications include:



Reduced circumstances in which a liquidator can seek to clawback an unfair preference payment from a creditor that is not related to the company.



Only requiring the liquidator to report to ASIC (under section 533) on potential misconduct where there are reasonable grounds to believe that misconduct has occurred.



Removing requirements to call creditor meetings and the ability to form committees of inspection.



Simplifying the dividend process (where creditors receive a return proportionate to their debt) and the proof of debt process (where creditors provide information as to the debt they are owed, which is assessed and accepted or rejected by the liquidator).



Maximising technology neutrality in voting and other communications.

The rights of secured creditors and the statutory rules as to the payment of priority creditors such as employees will not be modified.

**Who can access the simplified liquidation pathway?**

The process would be accessible to incorporated businesses with liabilities of less than \$1 million (the same threshold that would apply to the new restructuring process).

**What protections will be in place to prevent misuse of the simplified pathway, such as illegal phoenix activity?**

Safeguards will be included to prevent companies from using the process to undertake corporate misconduct, including firms seeking to carry out illegal phoenix activity.

This includes allowing creditors to convert the liquidation back to a 'full' process, and preventing directors from using the process more than once within a prescribed period (proposed at 7 years). Company directors seeking to use the process would also be required to declare that they believe the company is eligible and has not engaged in illegal phoenixing.

The Government also implemented earlier this year a suite of reforms to the corporations and tax laws to combat illegal phoenix activity.

One of the main problems with Australia's insolvency processes is that too much time and expense goes into winding up businesses with few or no recoverable assets - *Productivity Commission, Business Set-Up, Transfer And Closure, 2015*

**Further measures to support our insolvency system**

Unfortunately, many businesses both large and small have become insolvent due to the economic consequences of COVID-19.

On 22 March 2020 the Government announced temporary relief for financially distressed companies, to provide the opportunity for as many businesses as possible to survive. On 7 September 2020 the Government announced a further extension of this relief to 31 December 2020.

The extended relief includes reforms to insolvency laws to provide:

- A temporary increase in the threshold at which creditors can issue a statutory demand on a company from \$2,000 to \$20,000, and a temporary increase in the time companies have to respond to statutory demands they receive from 21 days to 6 months.
- Temporary relief for directors from any personal liability for trading while insolvent, with respect to any debts incurred in the ordinary course of the company's business.

As this temporary relief ends, there will be an increase in the number of businesses entering external administration or seeking to use the new small business debt restructuring and liquidation processes.



The Government is introducing a number of permanent and temporary measures to expand the availability of insolvency practitioners to deal with this expected increase in the number of businesses seeking to restructure or liquidate.

These are:



Temporarily waiving fees associated with registration as a registered liquidator for approximately 2 years until 30 June 2022 to encourage more practitioners to enter or re-enter the market.



Making changes to allow for more flexibility in the registration of insolvency practitioners by removing requirements which are overly rigid, but do not provide demonstrated benefit in ensuring the integrity of the profession.



Making the key parts of the process set out in the Corporations Act 2001 'technology neutral' so that external administrations can be carried out more efficiently and administrators can focus on the substantive requirements of their role.



Providing temporary insolvency relief for eligible companies waiting to access the new restructuring process, where a company can announce its intention to access the restructuring process, then benefit from the existing temporary insolvency relief for up to 3 months until the process commences.



Establishing a new classification of insolvency practitioner whose practice will be limited to the new simplified restructuring process only.

...there is considerable scope to streamline insolvency processes for the majority of businesses through the creation of a two stream approach

- *Productivity Commission, Business Set-Up, Transfer And Closure, 2015*

Consultation will also be undertaken on the appropriateness of permanently raising the minimum threshold at which creditors can issue a statutory demand on a company.

# Insolvency reforms to support small business

Figure 1: Overview of the new restructuring process

