



Australian Government



Australian
**Small Business and
Family Enterprise**
Ombudsman



Insolvency Inquiry Report

July 2020

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Foreword

Australian small businesses and family enterprises have never done it tougher. At the end of 2019, many small businesses across the country were looking forward to 2020 with optimism, only to be hit with bushfires and floods. Where businesses survived these disasters intact, the images beamed around the world of our country burning led to a significant decrease in international tourists and holiday makers, leaving businesses and the supply chains that rely on them struggling for survival. When the necessary COVID-19 restrictions came into force, many businesses saw the hope of a bounce back drifting away from them.



The steps taken by the Government to support businesses and prevent insolvencies has been critical, saving many thousands of businesses and significantly more jobs in the process. Many businesses will be able to survive this economic turbulence and contribute strongly to a business-led economic recovery. Unfortunately, there are a number of businesses that may not be able to recover, many of which were already struggling before the multiple hits 2020 has delivered. For these businesses, and future businesses, it is critical that the process of winding up is quick, orderly, and dignified.

Experience tells us, however, that this is an unlikely outcome.

Following the completion of our inquiry into the banking sector's treatment of small businesses, we quickly identified a major issue in the insolvency process for the small business community. Often where small businesses are seeking support to turnaround their business in response to financial pressures, they find themselves on an express train to winding up with no control over the process. For many, the liquidation process has been so traumatic that they will never fully recover, let alone try to start a new business in the future.

Small business owners report facing an opaque system, where decisions are taken out of their hands, they feel pushed into outcomes they were not looking for, and their expertise or knowledge of the business they have been running is discounted or ignored. Business owners talk of stock being sold at a low point in the market, assets being put up for sale in publications that are not particularly relevant to their industry, and thousands being spent by registered liquidators to chase down payments worth less than one tenth of the amount spent. Unsecured creditors – most often small businesses themselves – see very little return from an insolvency process.

The system as it stands does not work for small businesses.

There are many reasons for this, but perhaps the most critical is the fact that the owner of the business is often cut out of the process as soon as they enter the insolvency space. It is important for everyone to remember that often, the reasons for a business failure are outside of the control of the business owner. We will sadly see a lot more of that in the coming months.

Crucially, all parties need to be reminded of what is at stake here. Business owners are not simply 'directors' of the business. They are people who have often poured decades of love and dedication into running a business to follow a passion and provide for their families. The businesses in question are not just 'companies'. They are the beating heart of our communities, supplying jobs, supporting local sporting teams, and lifting up their communities when it counts. When the industry talks about 'realising assets', they are often referring to the family home of the business owners. Clinical and technical language can lead policy makers and those who work in this space to forget that a business failure will often devastate people, not just the business. This is why we refer to 'small businesses' and 'business owners' throughout this report, rather than using technical language.

The hard reality is that not every business will survive their first few years of operation. And sometimes, established businesses cannot weather certain storms. But it is absolutely critical to our economy and

communities that we continue encouraging entrepreneurial Australians to give their dream a go. Designing a system that allows those who may not quite 'make it' this time a genuine turnaround process, specifically and exclusively for small businesses will make it far less daunting for those wanting to chase the dream of being their own boss. And, where things do not work out, a system that allows those people to wrap things up quickly, affordably, and with dignity, so that they can get back on their feet as soon as possible and look to the future, will go a long way to ensuring the small business community retains its fighting spirit.

A handwritten signature in black ink, appearing to read 'Kate Carnell', written in a cursive style.

Kate Carnell
Australian Small Business and Family Enterprise Ombudsman

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Findings and Recommendations

Access to timely support

Finding: Small business owners know their business best and know when to seek advice. However, suitable professional advice can be hard to find and difficult to fund.

Recommendation 1: Small Business Viability Review

- a) Establish a Small Business Viability Review program where small business owners in significant financial stress – for example, a 20% reduction in cashflow on a rolling 12 month basis – or where a systemic shock has been declared can obtain a voucher of up to \$5,000 to access tailored advice on how to improve the operation of their business, or, where the advice is to wind up the business, to implement that.
 - i. A business owner (or their representative, for example, their accountant) would apply for an initial voucher of up to \$3,000 with services provided by an appropriately accredited professional. The services provided would assess the current financial position of the business, its viability as an ongoing concern and advising on issues and options of turnaround or exit.
 - ii. Should the advice indicate that the business should be wound up, an additional \$2,000 will be made available for a registered liquidator.
 - iii. For services provided, payment will be made directly by government up to the maximum allowable value.
- b) Expand the existing concierge service offered by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) to support the Small Business Viability Review program to help small business prepare for and access the program where a small business does not already have a trusted financial advisor.
- c) The Australian Taxation Office (ATO) and Australian Securities and Investments Commission (ASIC) should include details of the Small Business Viability Review program and the ASBFEO concierge service in current ATO and ASIC compliance notices. In addition, the ASBFEO will work with the ATO to update the ATO's business viability assessment tool for the new system and ensure that the tool works appropriately in times of crisis, such as natural disasters, and in the current COVID-19 pandemic.
- d) The Small Business Viability Review scheme program will be reviewed after 2 years of operation and every 3 years thereafter to assess the effectiveness of the scheme and to consider amendments where needed.

Response to systemic shocks

Finding: Australian businesses have always had to respond to natural disasters such as drought, floods, and bushfires. The COVID-19 pandemic, which has come on the back of wide-spread natural disasters, has shown that businesses need a mechanism where they can take stock of their situation and prepare for the re-opening of trade.

Recommendation 2: Small Business Debt hibernation

- a) Establish a *Small Business Debt Hibernation* instrument accessible to small businesses where a State, Territory or the Federal Government has declared a systemic shock such as those experienced during natural disasters, pandemics, significant economic down-turns or other crises.
- b) A minimum hibernation period of 90 days applies with Federal, State, or Territory Governments able to increase that period.

- i. During the Business Debt Hibernation period, small business owners will engage with creditors to reach an agreed period of hibernation of at least the minimum period, during which time payments on loans, rent, tax, and other ongoing payments can be deferred.
 - ii. When the business returns to trading, extended repayment of debts at the time of entering hibernation will be accommodated.
- c) During the period of the declared hibernation:
- i. New transactions with unrelated parties in the ordinary course of business are excluded from the voidable payments regime.
 - ii. There will be a moratorium on personal liability for insolvent trading.
 - iii. The ATO must not charge or must remit any interest and penalties related to the hibernation period.
 - iv. Small businesses will be able to utilise the Small Business Viability Review voucher during this period.

Recommendation 3: Limit small business bank debt escalation

The Australian Banking Association should amend subparagraph 179A(a) of the Banking Code of Practice such that it applies to small businesses generally as follows:

Where you are a farmer or small business and we have provided you with a loan for the purposes of your operation, we will not charge default interest (or any fee in lieu of default interest) on that loan during any period that your business is impacted by drought or natural disaster (which includes epidemics and pandemics).

Cost effective insolvency processes

Finding: External administrations are focused on maximising the return to creditors, irrespective of the cost of the process or the effect on the business. However, a restructure of business affairs, managed by the small business owner and with approval from a registered liquidator could have more positive outcomes, including providing a greater return to creditors.

Where businesses do need to be wound up, there is a concern that the cost of the process far outweighs any benefit to creditors, even where liabilities are small, and a business structure is simple.

Recommendation 4: Directors' Insolvency Agreement

Establish a *Directors' Insolvency Agreement* instrument for small businesses where owners of a business can provide a proposal to a registered liquidator on the best way to manage the business. The proposal may seek to restructure or to wind up the business, where a restructure must retain the existing company and a sale of the business and/or its assets must be to an unrelated party.

- i. Once the small business owner and liquidator enter into a *Directors' Insolvency Agreement*, an automatic 30-day moratorium from creditor actions and relief from insolvent trading commences.
- ii. Provided the liquidator is satisfied that there is no criminal misconduct and it is in the best interests of creditors after considering other alternatives, the liquidator would then approve the small business owner's proposal and report to creditors the estimated net benefit for each alternative considered and the rationale for approving the owner's proposal.
- iii. As part of the report to creditors, the liquidator would seek appointment to finalise the agreement with expenditure capped at their estimated total expenditure.

Recommendation 5: Simplified liquidation

For a small business where the deficit of the business (i.e. total liabilities less total assets) can be shown to be less than \$50,000 the owner may appoint a registered liquidator to commence a simplified liquidation where:

- i. The process will take no more than 30 days.
- ii. Costs will be capped at no more than \$10,500 and rise in line with the capped total as nominated by ASIC in its funding guidelines for registered liquidators under the Assetless Administration Fund.¹
- iii. Secured creditors are prohibited from taking enforcement action to recover their debt.
- iv. A registered liquidator will, without the requirement to rebuild any company books, realise the assets of the business, and distribute funds realised to all creditors, proportionate to the level of debt held, irrespective of ranking, once employee entitlements have been paid.
- v. The recovery of such assets must exclude the sale of the principal places of residence of company officers and guarantors.

Recommendation 6: Update statutory demands

For statutory demands served under section 459E of the *Corporations Act 2001 (Cth)*, increase the statutory minimum to \$5,000 and the statutory period to 30 days.

Recommendation 7: Ensure proportionate recoveries

Registered liquidators may only pursue recoveries during external administration where the expected net financial benefit to creditors is estimated to be at least 10% greater than the cost.

Modernised approach to information

Finding: Small business owners and other creditors believe that too much information is currently provided to all creditors, including where the information is of little relevance to some creditors. There is consensus that all reports should be available, by default, electronically. The requirement to attend meetings in person disadvantages creditors outside of capital cities.

There is a lack of clear information, available from a trusted, centralised point, regarding the process, objectives, implications, and impacts of external administration processes.

Recommendation 8: Simplify information

- a) ASIC should revise the *Insolvency Practice Rules (Corporations) 2016* to restrict the detailed information provided to creditors to the matters on which they can vote, relevant to the specific business under external administration.
- b) The initial creditors report to be prefaced by a clearly titled summary of not more than two pages outlining the strategies considered, expected total cost and net return to each rank of creditor for each strategy, and the reason for the proposed course of action pending creditors approval. The report will provide links for creditors who are interested to access and navigate the historical information on the business and generic information about creditors rights and insolvency processes.
- c) ASIC should create plain-language fact sheets targeted to small business owners which explains the different external administration options, legal implications of each and the obligations of, and impact on, the owner, their business, and any directors of the business.

¹ The funding guideline is described as of 16 July 2020 in ASIC RG109.41

Recommendation 9: Electronic communication

Communications regarding external administrations and all reporting should, by a default opt-out process, be electronic with amendments including:

- i. Section 600G of the *Corporations Act 2001 (Cth)* to require all notices, reports, and correspondence in relation to external administrations to be electronic unless the intended recipient requests otherwise.
- ii. Section 497 of the *Corporation Act 2001 (Cth)* to require the notice of a meeting to include details to attend by electronic means such as teleconference or video conference.

Proactive and targeted handling of complaints

Finding: Small business owners can understandably feel that an external administration has worked against their best interest. This does not necessarily mean that a registered liquidator, nor, indeed, a director, has been entirely without fault.

The current system of investigating complaints regarding external administrations is opaque, with improvement required on who can complain and the manner in which those complaints are investigated.

Recommendation 10: Better targeted investigation and recording of misconduct

- a) Where a Director's Information Number (DIN) record shows a director has been involved in three or more external administrations, or if there are more than three complaints about a director, over a rolling five-year period, ASIC must investigate the conduct of that director.
- b) The Australian Small Business and Family Enterprise Ombudsman (ASBFEO) should be designated a priority complainant under the *Corporations Act 2001 (Cth)*.
 - i. As a priority complainant, the ASBFEO would be empowered to substantiate serious complaints concerning practices of registered liquidators and office bearers.
 - ii. The ASBFEO will lodge a complaint with ASIC together with appropriate evidence.
 - iii. ASIC would be required to investigate the complaint and report its findings and proposed actions to the ASBFEO within 90 days.
- c) When an external administration uncovers possible misconduct by a director or a registered liquidator the cost of the investigation into that possible misconduct should be borne by ASIC.

Background

In 2016, the ASBFEO released the *Small Business Loans Inquiry* report which explored the impact of external administration on several small businesses.² These small business owners felt that there was a loss of control and a lack of transparency throughout the process; and with these businesses often being wound up, that particular process appeared poorly managed and resulted in less than ideal outcomes both for the owner of the business and its creditors.

On 10 October 2019, we launched the *Insolvency Practices Inquiry* to investigate the experiences of small and family businesses that operate in a corporate structure and have undergone external administration. We looked at both small businesses that have become insolvent and their small business suppliers who may have subsequently faced insolvency.

To support the inquiry, a Reference Group was formed with members drawn from the accounting, legal and small business advisory sectors, chaired by former Senator John Williams, a member of the Australian Senate for 11 years. The Reference Group acted as a forum for input and discussion on the themes and challenges faced by small and family businesses facing insolvency.

The terms of reference were to consider:

- The existing insolvency system through the experience of small businesses, in particular, where they may be able to contribute to the process.
- The degree of transparency of the governance, processes and costs of practitioners including legal experts, valuers, investigating accountants, administrators, receivers, and liquidators.
- How the insolvency of a small or family business may lead to bankruptcy for the owners.
- How the established framework impacts the practices and fees of insolvency practitioners.

The Inquiry commenced on 10 October 2019 and collected data through a variety of mechanisms including:

- A public survey, open from 10 October 2019 to 31 January 2020, which received 300 responses from small businesses around Australia
- A discussion paper released on 19 December 2019 with submissions received until 31 January 2020, which received responses from 16 industry bodies, industry participants, the academic sector, and ASIC.
- A consultation program with government departments, regulators, industry associations, insolvency practitioners, financial counsellors, and small businesses

Our recommendations have been formed based on responses from all of the forums mentioned, and we thank all of the participants who have assisted in the preparation of this report.

Finding: Access to timely support.

Small business owners know their business best and know when to seek advice. However, suitable professional advice can be hard to find and difficult to fund.

The responses from small businesses showed that the single largest party (over 40%) to commence external administration was small business owners themselves.

² Throughout this report, as with all considerations by the ASBFEO, we define a small business as one which has an aggregated turnover in a financial year less than \$10 million.

These small businesses cited a range of contributing factors including:

- to uphold their obligation as a director to not trade insolvent.
- external factors such as economic downturns.
- following advice from accountants and business advisors.
- acting on a pre-insolvency consultants' recommendation having sought advice to restructure the business.

As is noted in the body of this report, many small businesses consider there is no 'spare' cash to seek advice, even from their regular bookkeeper or accountant, and even less spare time. Government support services are few, even when a small business most needs to access advice.

For 20% of small businesses which underwent external administration, their bank appointed a receiver to collect and sell enough of the secured assets to repay the debt owed. Universally, these small businesses experienced a complete breakdown in communication and considered that it was the actions of the bank and costs of its receiver that devastated their business. As one former small business owner commented:

'[I had] no say and [there was a] refusal by bank or receivers to provide any information'

In 15% of responses, external administration was commenced by the ATO. Many small business owners expressed frustration regarding their experiences when dealing with the ATO; the greatest difficulty faced was being able to obtain an accurate figure of what they owed. Repeated calls to the ATO meant speaking to different people each time, and the information provided varied:

'I had tried to gain answers from the ATO but gave up and again contacted the insolvency advisor that had "helped" us with the liquidation of the company entity. He also did not get the correct information from the ATO.'

ATO fines and penalties meant that businesses found they were falling further behind:

'We went through financial difficulties and missed a payment to the ATO. The amount outstanding was around \$40,000 but with fees and penalties [applied by the ATO] it was impossible to get ahead.'

The ATO commenced external administration which, in an attempt to stop, we engaged a solicitor to attend court proceedings at a cost of \$10,000 with no positive outcome.

The receiver [appointed by the ATO] claimed we owed in excess of \$300,000. We had to engage a [legal] firm to help us navigate our way through at a cost of \$30,000.

The receiver eventually settled for \$60,000. The ATO received no distribution as these funds paid the costs of the receiver."

Finding 2: Response to systemic shocks

Australian businesses have always had to respond to natural disasters such as drought, floods, and bushfires. The COVID-19 pandemic, which has come on the back of wide-spread natural disasters, has shown that businesses need a mechanism where they can take stock of their situation and prepare for the re-opening of trade.

The ASBFEO has heard from many small businesses who have struggled with the realities of bushfires and closures associated with COVID-19. In the main body of the report we include the story of a regional motel which would normally expect to make 70% of their annual revenue during the peak season. They were closed first due to bushfires – which also resulted in the business returning deposits they had taken for bookings during the period – and then again with COVID-19 restrictions. Even the most well-prepared business would struggle to survive these sorts of systemic shocks.

Finding: Cost effective insolvency

External administrations are focused on maximising the return to creditors, irrespective of the cost of the process or the effect on the business. However, a restructure of business affairs, managed by the small business owner and with approval from a registered liquidator could have more positive outcomes, including providing a greater return to creditors.

Where businesses do need to be wound up, there is a concern that the cost of the process far outweighs any benefit to creditors, even where liabilities are small, and a business structure is simple.

Responses from small businesses showed the clear majority (63%) of owners which had been through an external administration process considered that, once a registered liquidator was appointed, the focus of the liquidator and the creditors was on winding the business up, rather than considering a restructure.

'...the bank would not talk to our legal representatives and re buffed any budget or plans to pay back the loan.'

Of significant concern is that small businesses willingly enter voluntary administration on the (possible mis-) understanding the process could provide them an opportunity to restructure. That the registered liquidator must take full control of the business and make all business decisions is unclear to many small business owners at the start of the process:

'That's why we appointed them to help restructure. They promised (to help) but sold everything'

In the 25% of cases that did consider restructure, there was a mix between a successful restructure and progressing to liquidation. For those that wound up, a restructure was considered high risk and not the best outcome for creditors. For those that restructured, it was usually at the initiative of the owner (for example, seeking refinancing), rather than through the actions of the registered liquidator.

28% of small businesses felt involved in the external administration process and that their experience with the registered liquidator was positive. These owners, perhaps unsurprisingly, considered the outcome achieved was the best option and reflected the registered liquidator having industry specific knowledge.

Worryingly, in almost one in five responses (19%) small business owners found that, while the registered liquidator was initially engaged by the owner, once the owner had provided their financial records and a general overview of the business, they were shut out of their business and locked out their commercial premises, or even their houses. Over 50% of small business owners felt 'locked out' of their business from the start, with no involvement in the process whatsoever.

'Once our accountant highlighted the potential issue and we consulted a lawyer, it all happened pretty quickly afterward... effectively we were sidelined quickly.'

'(We were) not allowed any involvement in the insolvency process. We were prevented from entering all properties by security guards, including being locked out of our house.'

One of small business owner's key concerns was that the registered liquidator held no understanding of their industry:

'The receivers appointed by the bank had absolutely no experience with agriculture. We frequently had phone calls from the receiver asking 'where would I sell the wheat? What does the boom spray look like, again?'

They re-negotiated longstanding contracts to purchase the grain and hay harvested that were paying market price, to contracts that would pay approximately half the market value but pay within three days not the industry standard of 30 days.

We had our machinery listed with specialist dealers, located in the area, yet the receiver withdrew the machines from sale and placed them in an auction in an area where there was no broadside cropping. No machine realised more than 50% of its value.

To view our operation, the receiver drove the 400km to meet with us on the farm bringing along three other people. The receiver charged us travel costs at \$200/hr for the junior accountant and

\$500/hr for the other two.

While the receiver undervalued everything we owned and our time, they charged exorbitant rates for their time. Instead of having \$300,000 equity when we left, after a year in receivership, we had debts of \$1.2m.'

From the 28% of owners that felt involved in the process, only 8% considered the sales process had achieved a satisfactory outcome, where satisfactory was defined as:

- all creditors being paid what they were owed; and
- all employees receiving their entitlements'; and
- the owner exited the business carrying no debt.

All responses, even those that were satisfied, indicated that the sale process marketed assets as 'fire sales' resulting in offers well below market value. For many, there was a significant disconnect between what they believed assets to be worth, having purchased them for the business, and the sale value.

93% of small businesses involved in a sales process considered the time and cost associated with the process was unreasonable. Small businesses found the actual cost and the time taken was greatly in excess of initial estimates. A commonly held perception was that registered liquidators extend an external administration process as long as there are assets that can be realised to reimburse their fees.

'[Registered liquidator] during meetings before appointment indicated that a restructure would be their primary goal and that they would provide assistance to set up a Deed of company arrangement (DOCA).

They estimated that their total fees would be \$250,000 and that the administration would take around 6 weeks.

Their fees have totalled over \$1 million and continue to increase after 2 years. The liquidation is still not complete.'

Importantly, the sense that the fees charged were unreasonable was keenly felt by those small businesses who were creditors to other small businesses. As their debt was unsecured, they received no distribution with the view that the costs of the registered liquidator frequently used up all the funds available.

'Being an unsecured creditor like most small businesses, [I] have not received a cent from the administrators. They paid the ATO, banks, took what was left and said goodbye.'

Submissions to the discussion paper generally shared a concern with the cost of the external administration process. They generally agreed (68% support) that there should be a control mechanism to prevent the total costs of an external administration from consuming the value of the company's assets. Registered liquidators noted that the most significant costs for any external administration is undertaking investigations required to meet their statutory obligations, and that cost controls could compromise the thoroughness of this investigative process. Registered liquidators also raised that the current framework gives creditors the control over costs through voting.

There was consensus across submissions to the discussion paper that the current framework, the same processes irrespective of the size of businesses, does not work for small businesses. Submissions proposed alternatives including streamlining the system (especially regarding the number and complexity of reporting requirements), controls over costs and using a levy on the industry to pay liquidators' fees.

Finding: Modernised approach to information

Small business owners and other creditors believe that too much information is currently provided to all creditors, including where the information is of little relevance to some creditors. There is consensus that all reports should be available, by default, electronically. The requirement to attend meetings in person disadvantages creditors outside of capital cities.

There is a lack of clear information, available from a trusted, centralised point, regarding the process, objectives, implications, and impacts of external administration processes.

There was consensus in submissions to the discussion paper that all other documents associated with a process being undertaken by a registered liquidator should be provided electronically, especially given that the preparation of physical paper reports, and the provision of these reports through the mail can be a major cost on the external administration process. 69% agreed that a registered liquidator's Annual Administration Return, as lodged with ASIC, should be made automatically available to creditors.

“Providing information is important however providing clear and relevant information is more important than volume”

ASIC themselves have identified that a key failing of creditors' reports was that the information was 'generic, not company specific or customised, and creditors were unable to decide if the remuneration claimed was necessary or proper.' ASIC further found that such generic reports meant 'creditors lacked interest or motivation to vote'.

All submissions to our discussion paper agreed that a plain language fact sheet should be available for small business owners that explained the different external administration options, legal implications of each and the obligations of, and impact on, the owner, their business, and any directors of the business. General consensus was that the Australian Securities and Investments Commission (ASIC), as the regulator of corporate insolvencies, would be best placed to prepare this information. In particular, this information would provide some protection against unregistered and unregulated "pre-insolvency advisers".

Finding: Proactive and targeted handling of complaints

Small business owners can understandably feel that an external administration has worked against their best interest. This does not necessarily mean that a registered liquidator, nor, indeed, a director, has been entirely without fault.

The current system of investigating complaints regarding external administrations is opaque, with improvement required on who can complain and the manner in which those complaints are investigated.

In 100% of responses from owners of small businesses considered the remuneration paid to the registered liquidator excessive. For the overwhelming majority, the manner in which assets were sold appeared to be driven by the registered liquidator such that the sale would raise money quickly and allow the liquidator to recoup their costs. Maximising the benefit for creditors appeared a secondary consideration. Yet very few complaints to either ASIC or the industry body are examined for impropriety – rather complaints usually find that no laws have been broken.

It was acknowledged by respondents to our discussion paper that when creditors do lodge a complaint about remuneration to ASIC, very few are investigated.

Current insolvency framework

The framework for managing insolvencies is contained within the *Corporations Act 2001 (Cth)* (the Act) and the *Corporations Regulations 2001 (Cth)*. Chapter 5 of the Act contains the legislative framework for the different forms of external administration including schemes of arrangement, receivership, voluntary administration (VA), Deed of Company Arrangement (DOCA), and voluntary and compulsory liquidation. Of these, voluntary administration, liquidation, and receivership are the most common.

The voluntary administration (VA) vehicle is intended to resolve the future of a business quickly when it is experiencing financial problems. It requires the owners to engage a registered liquidator in the role of administrator to take control and work out a way to save the business. In the retail sector, large groups such as Jeanswest, Tigerlily and Bardot have restructured through a VA. In each case, being a large business has been key to the success in restructuring as it has allowed the ability to close underperforming stores, reduce staff where needed, and reduce overheads. The VA process may also result in a DOCA, where creditors agree to an arrangement which allows the business to continue trading and pay debts over time. The time and cost to undertake a VA, the cost of a liquidator monitoring a DOCA, mean these are not viable alternatives for small businesses.

A receivership occurs when a secured creditor of a business appoints a registered liquidator, as receiver or receiver and manager, to collect and sell enough assets within the business to repay their debt. A business may continue to trade once the receivership is complete, although there is rarely any equity remaining and most often the business has to be wound up.

A liquidation allows for the winding up of a company's operations and financial affairs. They can be ordered through a court, or by a vote of creditors or members and generally follow an administration event. In this instance, it is the role of the registered liquidator to realise all of the company's assets and distribute the proceeds to creditors and shareholders, in order of ranking, in the business.

ASIC, as the government regulator, monitors external administrations to assess if the insolvency process operates efficiently, honestly, and fairly. ASIC reports on its regulation of registered liquidators annually. The obligation for registered liquidators to report to ASIC varies according to the role they hold in an external administration. For example, a registered liquidator may first be appointed under a voluntary administration in the role of Administrator. On completion of the voluntary administration, where creditors chose to place the company into liquidation, the same registered liquidator may then be appointed in the role of Liquidator to wind up the company.

Irrespective of role, registered liquidators are required to lodge an initial external administrator's report when they suspect civil or criminal misconduct or estimate that the return to unsecured creditors will be less than 50c in the dollar. Of the 7,498 initial reports lodged between July 2018 – June 2019, the vast majority were lodged (92.5%) by a registered liquidator in the role of a Liquidator appointed to wind up the company.

The following statistics therefore reflect the financial position of companies on entering liquidation. In most cases this will be after administration or receivership during which assets are sold and the proceeds distributed to priority and secured creditors.

Between July 2018 – June 2019, for companies entering liquidation³:

- 85% had assets of less than \$100,000, 58% had less than \$10,000, and almost 37% were reported as assetless. Only 8.5% of companies had assets over \$250,001.
- Almost 76% had liabilities of less than \$1m; 38% had less than \$250,000
- 76% had less than 20 employees: 62% with 5 or fewer
- Slightly over 81% had no outstanding employee wage entitlements

³ <https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-645-insolvency-statistics-external-administrators-reports-july-2018-to-june-2019/>

- 52% had no outstanding superannuation guarantee (SG), a further 37% had outstanding SG of less than \$100,000
- 89% had less than 50 unsecured creditors
- 92% estimated the return to unsecured creditors would be \$0.

These figures suggest that the current framework, which in theory is structured to maximise returns to creditors, fails to operate efficiently when 92% of liquidations return no money to the unsecured creditors, the majority of creditors.

Throughout this report, in our consultations, and in the development of the recommendations, is the awareness that that the majority of creditors to small businesses are small businesses themselves with their debt unsecured. Should the small business creditor receive little or no distribution it can have a major impact in turn on that small business. We have tried to ensure that all small businesses are treated fairly, whether as the small business considering a restructure or closure, or as a creditor to that small business.

Access to timely support

Recommendation 1: Small Business Viability Review

- a) Establish a Small Business Viability Review program where small business owners in significant financial stress – for example, a 20% reduction in cashflow on a rolling 12 month basis – or where a systemic shock has been declared can obtain a voucher of up to \$5,000 to access tailored advice on how to improve the operation of their business, or, where the advice is to wind up the business, to implement that.
 - i. A business owner (or their representative, for example, their accountant) would apply for an initial voucher of up to \$3,000 with services provided by an appropriately accredited professional. The services provided would assess the current financial position of the business, its viability as an ongoing concern and advising on issues and options of turnaround or exit.
 - ii. Should the advice indicate that the business should be wound up, an additional \$2,000 will be made available for a registered liquidator.
 - iii. For services provided, payment will be made directly by government up to the maximum allowable value.
- b) Expand the existing concierge service offered by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) to support the Small Business Viability Review program to help small business prepare for and access the program where a small business does not already have a trusted financial advisor.
- c) The Australian Taxation Office (ATO) and Australian Securities and Investments Commission (ASIC) should include details of the Small Business Viability Review program and the ASBFEO concierge service in current ATO and ASIC compliance notices. In addition, the ASBFEO will work with the ATO to update the ATO's business viability assessment tool for the new system and ensure that the tool works appropriately in times of crisis, such as natural disasters, and in the current COVID-19 pandemic.
- d) The Small Business Viability Review scheme program will be reviewed after 2 years of operation and every 3 years thereafter to assess the effectiveness of the scheme and to consider amendments where needed.

Summary

- There are many causes of financial stress in small businesses including unpaid invoices, extended payment terms, unexpected changes in staff and changes in government legislation.
- When cash flow pressure mounts small businesses will prioritise meeting fixed obligations to keep their business running such as rent, utilities and wages.
- Small businesses frequently find there is no 'spare' cash to seek advice, even from their existing bookkeeper or accountant.
- Where owners do seek advice, it is when they have time outside ordinary business hours so rely on the internet.
- The top results from internet searches are sponsored sites for managing debt that direct owners to unlicensed, unregulated business consultants, often offering the first consultation for free and which may advocate illegal phoenixing arrangements.
- A Government sponsored program is needed for owners to prioritise seeking tailored advice early with the cost for the professional not coming out of the cash flow of their business.

Proposal

ASIC publishes statistics regarding the most common causes registered liquidators nominate for business insolvency. The top three, in order of prevalence are:

- Inadequate cash flow (51.2%)
- Poor strategic management (42.9%)
- Trading losses (38.9%)⁴

It should be noted that the raw statistics, however, may not provide a complete story. For example, when considering inadequate cash flow, this could be caused by the result of late payments by a customer, not necessarily the owners' ability to operate and manage their business appropriately. That point notwithstanding, ASIC statistics, submissions to our discussion paper, and views expressed in consultations with insolvency practitioners and industry bodies, have all raised concerns that owners of small businesses often leave it too late to seek help.

Financial counsellors and small business mentors have found that as cash flow pressure mounts small businesses prioritise meeting costs needed to keep their business running such as rent, utilities, and wages. Many small businesses consider there is no 'spare' cash to seek advice, even from their regular bookkeeper or accountant, and even less spare time. Unfortunately, there are few government support services, such as financial counselling, available to small businesses at the time when they need it most.

As this Office heard through the responses from small businesses in our survey, owners do recognise financial stress and do seek support. The responses reflected the experiences of the counsellors and mentors that the key barrier is how to find, and then fund, trusted tailored advice.

"Most legal advice was not affordable, and any free legal advice declared our situation too complex."⁵

Our survey discovered that roughly half of small business owners which had been involved in an external administration process had sought advice and from multiple sources including legal experts, accountants, insolvency practitioners, and government agencies. Legal experts ranged from a local solicitor recommended by the accountant of the small business through to barristers engaged to defend actions in court. Insolvency practitioners included both pre-insolvency consultants, approached to assist in managing debt, and registered liquidators.

A persistent comment from those that tried to find advice was the complexity involved in finding the right advice, and the high cost of that advice. For those that sought advice they found it simply added to the costs, while for those that did not eventually seek advice, it was the expected cost to get that advice that prevented them even trying.

Owners of small businesses often fill every role within their business, from managing the accounts, acting as the human resource department, and working in sales and production. As such, they typically seek help outside of ordinary business hours by doing internet searches. These searches return sponsored sites first, with many of these firms offering an initial consultation free of charge, and some may advocate illegal phoenixing arrangements. Programs and information provided by government agencies, such as business mentors and the ATO Business viability assessment tool, are not sponsored and as such are listed further down in search results and are often overlooked.

It can be both difficult and time consuming to identify if a debt advisory consultant is accredited with an industry or government body that can hold them accountable for the support provided. This is especially true where that consultant is chosen through an internet search. Both the ATO and ASIC have, at different

⁴ ASIC Report 645 - Insolvency statistics: External administrators' reports (July 2018 to June 2019), December 2019, page 18

⁵ Response IIS022 to our small business consultation

times, trialled notices to advise business owners on warning signs to watch for to indicate that an adviser is not trustworthy. Appendix A includes an example used by the ATO.

Given that it can be difficult for a small business to find the money to seek advice – and this is even more true for a small business which may be in financial hardship already and therefore has an immediate need for the advice – and then to find an appropriate professional, this Office is calling for a Government funded program to provide for tailored advice from accredited providers.

Story from a small business: Transport company

A respondent to our survey advised that, realising they were experiencing cash flow issues, and the fact that their accountant's firm was closed over the Christmas/New Year period, they had used an internet search to contact a debt advisory firm.

An obligation free meeting was offered and present at that meeting was a director of an associated company. The transport company's owners were not consulted, asked for consent, or advised that this representative was to be in attendance. This concerned the operators as they had handed over detailed financial information to the debt advisory firm.

The director of the associated company recommended the transport company's owners signed a Voluntary Administration documentation. The owners were told that the voluntary administration would provide them with some 'breathing space' whilst the company restructured. At no point were the owners offered the opportunity to go through their financial records in detail or discuss what alternative options were available.

Shortly after the meeting an auctioneer arrived at the business premises. The owners asked if he was there to do a valuation on the assets for the voluntary administration. The auctioneer responded that the valuation was to prepare the assets for an auction as the liquidators were closing the business.

Accountants and bookkeepers can assist the owner to recognise financial stress and refer the owner to a registered liquidator when it is evident the business will become insolvent if action is not taken. Similarly, financial counsellors and business mentors will assist an owner up to a point before encouraging them to seek advice from registered liquidators to maximise the possibility of a successful restructure or reorganisation.

The voucher program, therefore, must encompass accredited professionals with small business expertise from across the accountancy, financial counselling, mentoring and turnaround industries. Further, that redemption, up to the maximum of \$5000, can be by more than one professional. This will accommodate, for example, an accountant undertaking a viability review then referring the small business to a registered liquidator who is best placed to assess if a proposed restructure achieves the best outcome for creditors, shareholders and the owner of the small business.

The inclusion of what should be within the scope of a viability review should have minimal prescription to allow tailored advice. By limiting the service providers to accredited professionals, the relevant codes of conduct ensure that individuals will work within their expertise and refer a small business to a registered liquidator when necessary. A template for key elements for consideration in a viability review should be in line with the ATO's Business viability assessment tool as this would provide consistency in the program and allow benchmarks for viability to emerge. It would also support, where the review determines the best outcome is to restructure, the review to form the basis of a proposal to enter a Directors Insolvency Agreement (see Recommendation 4).

We recognise that not all small businesses will have a regular bookkeeper or accountant, and as such we are proposing a concierge service to support the voucher program. As a trusted advocate for small

business, the ASBFEO understands the needs of a small business and works closely with the professional bodies whose members would be able to provide a viability review. The concierge service will assist a small business to identify what type of support they need and the records they will need to provide, as well as provide a list of appropriate accredited professionals to undertake the viability review.

The final and critical step is making small businesses aware of the voucher program and concierge service at the time when it is needed. Due to the statutory obligations on a small business the ATO and ASIC are well placed to identify early signs of financial stress. We propose these agencies could utilise their statutory notices, in the first instance, as an opportunity to raise awareness with small businesses of the support services available to assist with a review of their financial health.

Responses to systemic shocks

Recommendation 2: Small Business Debt hibernation

- a) Establish a *Small Business Debt Hibernation* instrument accessible to small businesses where a State, Territory or the Federal Government has declared a systemic shock such as those experienced during natural disasters, pandemics, significant economic down-turns or other crises.
- b) A minimum hibernation period of 90 days applies with Federal, State, or Territory Governments able to increase that period.
 - i. During the Business Debt Hibernation period, small business owners will engage with creditors to reach an agreed period of hibernation of at least the minimum period, during which time payments on loans, rent, tax, and other ongoing payments can be deferred.
 - ii. When the business returns to trading, extended repayment of debts at the time of entering hibernation will be accommodated.
- c) During the period of the declared hibernation:
 - i. New transactions with unrelated parties in the ordinary course of business are excluded from the voidable payments regime.
 - ii. There will be a moratorium on personal liability for insolvent trading.
 - iii. The ATO must not charge or must remit any interest and penalties related to the hibernation period.
 - iv. Small businesses will be able to utilise the Small Business Viability Review voucher during this period.

Recommendation 3: Limit small business bank debt escalation

The Australian Banking Association should amend subparagraph 179A(a) of the Banking Code of Practice such that it applies to small businesses generally as follows:

Where you are a farmer or small business and we have provided you with a loan for the purposes of your operation, we will not charge default interest (or any fee in lieu of default interest) on that loan during any period that your business is impacted by drought or natural disaster (which includes epidemics and pandemics).

Summary

- The current insolvency framework assumes that the failure of a business is due to poor management of that business. Yet, when an exogenous shock stops an economy, even the best managed businesses may not survive.
- While governments may offer a raft of packages to support small businesses and allow them to recover from such shocks, the assistance is not guaranteed, is inconsistent across jurisdictions, varies with each shock and often delays, rather than mitigates, the impacts.
- To provide confidence for small businesses to start, grow, innovate, and take risks requires the security of knowing that, where an exogenous shock negatively impacts their business, there is an option to hibernate their business debts, restructure and continue trading.
- Equally, to mitigate risks for providers of credit and suppliers to small businesses in hibernation, payments received during hibernation must be quarantined from the voidable payments regime.

- The ATO applies interest and penalties to drive compliance, yet the impacts of an exogenous shock can impact a business's ability to be compliant. Penalties simply compound any debt and prevent a return to trading.
- Equally, members of the ABA reserve the right to apply penalty interest to offset the costs of managing a loan facility in default. Where that default is triggered by a systemic shock, penalty interest will simply compound the debt with no realistic prospect of recovering any debt.

Proposal

Since July 2019, small business across Australia has been devastated by a sequence of natural disasters – drought, floods, and fire. As recovery was on the horizon, COVID-19 reached Australia. The necessary lockdown measures instigated by Governments to contain the spread of the coronavirus eliminated any chance of a quick economic recovery.

Stories from a small business: Regional motel

Under normal conditions, motel accommodation is a highly competitive marketplace with many beds available. During their peak period, December through to Easter, the small business in question earns 70% of its annual revenue.

Based in the Gippsland region, the owners were ordered to evacuate on 2 January 2020 as bushfires ravaged businesses and homes in the area. Access to the area was closed, resulting not only in a loss of possible revenue for the motel, but a loss of cash on hand as they had to refund the deposits for bookings in January 2020.

Access to the area opened by the end of January 2020 and over the Australia Day weekend the occupancy rate reached 72%. Soon, Government restrictions to manage the spread of COVID-19 came into force. The travel restrictions meant that once again the motel had to close.

The monthly rent on the premises is over \$16,000. The owners had used all of their business and personal savings. The owners contacted the Rural Financial Counselling Service (RFCS) for assistance as the rent was in arrears by two months and the owners could not afford to pay a gas bill of around \$2,000.

The RFCS purchased some gas bottles so the owners could keep cooking for their family of five on the single burner camping stove.

All levels of government have instigated measures to ease financial obligations, and these have been welcomed by the small business sector. Yet a recent survey undertaken by the Small Business Commissioner NSW⁶ found that only 31% of business are confident about their business prospects over the next 12 months, while 44% are extremely or fairly worried. For 66% of respondents, cash flow remains the greatest challenge to survival and the majority expect it will take over a year for revenue to return to pre-COVID-19 levels, if at all.

The current reprieve from insolvent trading, including changes to statutory demands, provides an ideal window to undertake a viability review and, where a business will not be viable as lockdown measures are lifted, wind it up in an orderly way.

For viable small businesses, recovery may require their creditors sharing the financial burden of recovery. The two primary creditors of small business are the ATO and their lender, generally a bank. Many

⁶ Small Business Commissioner, Small Business COVID-19 Survey Wave 3 – Full Report, May 20, 2020

experiences shared through our survey considered that it was the application of interest and penalties by the ATO which pushed their business into insolvency. Similarly, as noted in our 2016 *Inquiry into Small Business Loans*, we heard of many cases where the requirement to meet increased bank loan repayments due to penalty interest, which was often more than double the original interest, led to insolvency.

The response by the ATO and banks to the recent natural disasters and pandemic should be applauded: it has enabled many small businesses to survive and plan a return to trading. These recommendations seek to secure key elements of the support shown, by formalising it in legislation such that these actions can be put into effect when needed.

While the economic landscape after a systemic shock will always be unclear, realistically businesses will not be able to reopen if they are penalised for defaults and debts which arise during the period disruption. The limited resources of small businesses must be prioritised for working capital, and to allow the business to re-open, and re-engage their staff.

Cost effective insolvency processes

Recommendation 4: Directors' Insolvency Agreement

Establish a *Directors' Insolvency Agreement* instrument for small businesses where owners of a business can provide a proposal to a registered liquidator on the best way to manage the business. The proposal may seek to restructure or to wind up the business, where a restructure must retain the existing company and a sale of the business and/or its assets must be to an unrelated party.

- i. Once the small business owner and liquidator enter into a *Directors' Insolvency Agreement*, an automatic 30-day moratorium from creditor actions and relief from insolvent trading commences.
- ii. Provided the liquidator is satisfied that there is no criminal misconduct and it is in the best interests of creditors after considering other alternatives, the liquidator would then approve the small business owner's proposal and report to creditors the estimated net benefit for each alternative considered and the rationale for approving the owner's proposal.
- iii. As part of the report to creditors, the liquidator would seek appointment to finalise the agreement with expenditure capped at their estimated total expenditure.

Recommendation 5: Simplified liquidation

For a small business where the deficit of the business (i.e. total liabilities less total assets) can be shown to be less than \$50,000 the owner may appoint a registered liquidator to commence a simplified liquidation where:

- i. The process will take no more than 30 days.
- ii. Costs will be capped at no more than \$10,500 and rise in line with the capped total as nominated by ASIC in its funding guidelines for registered liquidators under the Assetless Administration Fund.
- iii. Secured creditors are prohibited from taking enforcement action to recover their debt.
- iv. A registered liquidator will, without the requirement to rebuild any company books, realise the assets of the business, and distribute funds realised to all creditors, proportionate to the level of debt held, irrespective of ranking, once employee entitlements have been paid.
- v. The recovery of such liabilities must exclude the sale of the principal places of residence of company officers and guarantors.

Recommendation 6: Update statutory demands

For statutory demands served under section 459E of the *Corporations Act 2001 (Cth)*, increase the statutory minimum to \$5,000 and the statutory period to 30 days.

Recommendation 7: Ensure proportionate recoveries

Registered liquidators may only pursue recoveries during external administration where the expected net financial benefit to creditors is estimated to be at least 10% greater than the cost.

Summary

Directors Insolvency Agreements and simplified liquidation

- The owners of a small business are the people best placed to know what needs to be done to keep their business going, who are its customers and its competition.
- An ability for owners of the business to develop and action a proposal, coupled with minimal statutory reporting obligations to reduce costs, will help small businesses to act early and be in a position to restructure, retain employees and sustain commercial relationships or, where not possible, close their business and exit with dignity and in a timely manner.
- While a voluntary administration is intended to provide a business with time to restructure, the time and money expended to meet statutory obligations and undertake investigations leaves no assets to support a small business restructure.
- Statutory reporting should be required only where the information provided can, and will, be acted on. For example, registered liquidators should report possible phoenix or illegal activities but not be required to undertake investigations or lodge multiple reports where they are satisfied they can find no evidence of these activities.
- As the majority of creditors to a small business are also small businesses, winding up a small business must maximise the return for all creditors to ensure the economic impact of closure is not compounded by several more small businesses being unable to survive.
- The ASBFEO notes that while there are considerations regarding company debts being transferred to personal liability, such considerations are beyond the scope of this review. However, we do recognise that these matters would need to be resolved in the implementation of this recommendation.

Update statutory demands

- Being able to issue a statutory demand for as little as \$2,000 with only 21 days for a small business to adjust cash flow to meet such a demand, is not proportionate to the impact if a demand is not met, i.e. the legal presumption of insolvency.
- The timeframe of 21 days from the issuing of such a demand to pay that demand or defend through the court system is unrealistic if the debtor business needs to reprioritise cash flow or engage their own legal expert to defend the claim.
- An increase in the statutory limits must strike a balance between the right of the party issuing the demand to be paid with providing a realistic timeframe for the debtor business to validate and respond to such a claim.

Ensure proportionate recoveries

- If registered liquidators are required to pursue possible recoveries for the benefit of creditors, they should only do so to the extent that the recovery results in funds being available for distribution to creditors.

Proposal

Directors Insolvency Agreements and simplified liquidation

The ASBFEO has had significant involvement with hundreds of small businesses which have direct experience in external administration. One of the most common pieces of feedback is that owners commence a voluntary administration to turn their businesses around but end up losing their business and being unsure at which stage of the process this became a foregone conclusion. Many small business owners consider the operational decisions made by the registered liquidator contributed to the decline of their business.

Considering the diversity in small businesses across Australia it does appear unlikely that each of the 641 registered liquidators⁷ in Australia could have the expanse of knowledge and experience to manage the small businesses that make up the majority of the 7,000 plus liquidations each year. It is the owners that will know high and low seasons, fluctuations in staffing needs, what is critical maintenance and what can be postponed or who is a trusted supplier not simply the supplier at the least cost.

Stories from a small business: Regional Tavern

The owners of a tavern in a remote regional location, reliant on tourism, entered voluntary administration due to financial pressures. Subsequently the ATO appointed its preferred registered liquidator to undertake the administration.

The owners found themselves working more than 120 hours/ week ‘because the liquidator would not allow any additional staff.’

The owners raised the question, how does a liquidator sitting in an office in a capital city tell a tavern 600 kilometres away in a regional town what stock to order in January versus September?

The proposed Directors Insolvency Agreement would facilitate small business owners input to produce a more efficient and effective proposal of their business to be implemented within a maximum timeframe and with a capped cost, proportionate to the resources of small businesses. Restricting eligibility to exclude large businesses, excluding businesses that may meet the formal definition for a small business but which are part of a complex group structure will ensure the process cannot be misused by business that should be managed under existing mechanisms that are designed for use with large business. Requiring a registered liquidator’s approval means that statutory obligations to identify criminal misconduct and illegal phoenix activity will still be met.

Requiring the owners to develop, propose, and then action, on approval by a registered liquidator, a plan harnesses the internal corporate knowledge held by the owners and external expertise to negotiate with creditors held by the registered liquidator. Importantly, on approval, the owners and registered liquidator will both make decisions to achieve the same, agreed, outcome.

The key elements of the proposed Director’s Insolvency Agreement include:

- The use of templates and standard processes to ensure consistency for registered liquidators and creditors and minimal timeframes to implement.
- The moratorium on insolvent trading will provide a degree of surety for the small business owner that they can act to rearrange the affairs of their business to achieve the best outcome for them and their creditors.
- Noting that secured creditors will have had the opportunity to take enforcement action as a small business struggles to meet financial commitments, if they have not and it is left to the owner to take the initiative, secured creditors must be prohibited from commencing an enforcement action, such as appointing a receiver.⁸

⁷ ASIC Report 658 – ASIC regulation of registered liquidators: July 2018 to June 2019, April 2020, pages 37

⁸ In the instance of appointing a receiver, this disproportionately benefits the secured creditor who makes the appointment. Appointing a receiver also acts to duplicate costs as the actions taken by the receiver are only reported to the secured creditor who appointed them, and many actions will need to be repeated by the registered liquidator appointed by the owner.

- Require registered liquidators to undertake only those actions that will preserve the integrity of the agreement such as:
 - Investigating the history of the business only as far as necessary to form a view if criminal misconduct has been undertaken.
 - Ensuring that the sale of any business assets since the last tax return have been at market value and proceeds appropriately credited to the business.
 - Assessing if the proposed restructure, sale of business assets, or the business itself, will provide the best outcome for creditors, including that the assets are not sold to a related party.

Simplified Liquidation

There will be instances, unfortunately, where it is clear that a small business must be closed. This may become apparent through the proposed Small Business Viability Review, or, indeed, through an initial investigation by a registered liquidator. Where it is the case that the best outcome is to close a small business the overarching guideline must be that the process will be simple, quick, and be undertaken in a manner which maintains the dignity and well-being of the owners.

Where a small business has outstanding liabilities at the time of liquidation of less than \$50,000 the simplified process proposed will meet those guidelines. This Office recognises that placing a cap on the costs of the process will limit the services which a registered liquidator can perform. Therefore, the proposed process will not require a registered liquidator to rebuild a business's books. With the suggested eligibility based on a low limit on outstanding deficiency (net liabilities), it is highly likely that the creditors will be small businesses with an unsecured debt. Recognising that these creditors will be reliant on the payment of their debt we recommend that all creditors are ranked equally after employee entitlements have been paid so funds realised are distributed, proportionate to the level of debt held, irrespective of ranking.

It is an unfortunate reality that small business owners can currently have a family home sold to recover relatively minor debts where they have provided personal guarantees or are personally liable for remaining liabilities. It is plainly unfair and not in the interest of wider society that a debt of less than \$50,000 could result in the sale of a family home. The recommendation to exclude calling on the principal places of residence of company officers and guarantors to satisfy personal liabilities arising from the closure of the business through the simplified liquidation process recognises this.

Update statutory demands

The current regime is generous to creditors, allowing them to start the process that can place a business into liquidation for a debt as low as \$2,000. The process is simple; a creditor provides a statutory demand in the form of a request for payment with proof of debt attached, where that proof of debt is a simple affidavit saying an amount is due and payable. Documentation, such as invoices, need only be produced if a matter goes to court. The statutory demand does not need to be served on the owner of the business, rather, it can be posted to the registered office of the business. If not paid or set aside within 21 days, the business is deemed insolvent under law and a creditor can apply to the courts to place the business into liquidation.

While creditors of small business are frequently small businesses themselves and should, of course, be paid in a timely manner, many external factors impact the cash flow of a business. Therefore, when considering any increase to the statutory minimums for formal liquidation action to commence, a balance must be struck between the demands placed on the cash flow of small businesses and the requirement for providers of credit to have the ability to enforce repayment in a reasonable time frame.

Our consultations revealed broad agreement that the current statutory minimums were too restrictive. The minimums proposed here reflect learnings from our inquiry into, and review of, payment times and, more recently, supply chain finance. The minimum value reflects that the cost of ensuring payment and progressing to a statutory demand would erode any possible return for amounts of less than \$5000. The timeframe, of 30 days, reflects the maximum payment term small businesses need to be able to meet their obligations.

Yet the right to be paid, in full and on time, for the provision of goods and services appears less clear for creditors once a business enters external administration. A registered liquidator will identify any payments made by the business in the six months prior to entering external administration. Where a payment appears to have placed a creditor in a more favourable position than any other creditor, and that creditor should have suspected its customer was insolvent, the liquidator may seek recovery of that payment where the liquidator has reasonable evidence that the creditor should have been aware of the insolvency of the business.

The intent of such recoveries is to ensure every creditor is treated equally. Yet the cost to undertake such recoveries, which can lead to defending the claim in court, are funded from the assets of the business under external administration.

Proportionate recoveries

While the current framework does impose a requirement on the registered liquidator to try and work with the owners of a business, the potential remains for the relationship to break down. This is exacerbated because a registered liquidator must make decisions to maximise the potential benefit for creditors while the owners are expecting decisions to maximise the possibility of a restructure to continue trading.

From our survey and consultations the greatest frustration reported was not the process itself but the large increase from the estimated cost provided by the registered liquidator on first meeting, and on which the owner based their decision on which approach to take, and the total costs incurred by the time each process was completed.

Stories from a small business: Estimated versus actual cost

A small business entered voluntary administration (VA). In the minutes of the first creditors' meeting held in April 2016 the registered liquidator estimated the VA process would be completed by May 2016 and cost approximately \$60,000.

One month later, in the minutes from the second creditors meeting in May 2016, the registered liquidator claimed reimbursement for costs to date of \$184,000.

The reason provided for the additional cost being that the business traded for a single week longer than expected. The registered liquidator noted that they considered the additional costs in administration would mean there would be less to do in the liquidation.

Further strain arises due to the cost for registered liquidators of completing the minimum statutory requirements. The one-size-fits-all process requires extensive investigation of the current financial state of a business, the recent history leading up to the financial stress and requires reporting to ASIC at each step of the process. As a result, most voluntary administration processes are expensive, even when the liabilities or assets of the small business are small.

Consultations which this Office conducted with registered liquidators indicated that the minimum cost of even a straightforward voluntary administration was around \$12,000, while the average was nearer \$50,000. As the statistics published by ASIC indicate, as noted earlier, by the time the majority of businesses entered liquidation they had assets worth less than \$10,000.

This Office recommends that only where a registered liquidator reasonably expects net proceeds available to creditors from recoveries during external administration will be at least 10% greater than the cost to undertake the recovery, should those recoveries proceed.

Stories from a small business: Estimated versus actual cost (cont.)

The registered liquidator estimated a potential \$598,000 that could be recovered. The registered liquidator also estimated to undertake the recovery their remuneration would be \$563,318 plus other costs of \$104,000.

That is, the estimated cost to recover a potential \$598,000 to distribute to creditors was \$667,000. Not only would recovery action cost more than might be recoverable, such costs are incurred even where the action is unsuccessful and \$0 recovered.

Modernised approach to information

Recommendation 8: Simplify information

- a) ASIC should revise the *Insolvency Practice Rules (Corporations) 2016* to restrict the detailed information provided to creditors to the matters on which they can vote, relevant to the specific business under external administration.
- b) The initial creditors report to be prefaced by a clearly titled summary of not more than two pages outlining the strategies considered, expected total cost and net return to each rank of creditor for each strategy, and the reason for the proposed course of action pending creditors approval. The report will provide links for creditors who are interested to access the historical information on the business and generic information about creditors rights and insolvency processes.
- c) ASIC should create plain-language fact sheets targeted to small business owners which explains the different external administration options, legal implications of each and the obligations of, and impact on, the owner, their business, and any directors of the business.

Recommendation 9: Electronic communication

Communications regarding external administrations and all reporting should, by a default opt-out process, be electronic with amendments including:

- i. Section 600G of the *Corporations Act 2001 (Cth)* to require all notices, reports, and correspondence in relation to external administrations to be electronic unless the intended recipient requests otherwise.
- ii. Section 497 of the *Corporation Act 2001 (Cth)* to require the notice of a meeting to include details to attend by electronic means such as teleconference or video conference

Summary

- The current system relies on creditors through voting on resolutions submitted by the registered liquidator to manage the actions of registered liquidators.
- Typically, the majority of creditors, by number, are small businesses themselves, have an unsecured debt, little or no experience of the insolvency system, and will be placed under financial stress if their debt is not paid.
- The key information required by this majority of creditors is the net return they can expect and when it will be received.
- The information provided to all creditors must therefore:
 - be limited to the matters specific to the business under external administration on which the creditors can vote.
 - be prefaced with a short plain language summary of the reasons for the proposed action, expected timeframe to complete and the net benefit to each rank of creditor.
- Information should be provided so creditors can choose to understand how they can challenge the actions of a registered liquidators, written with the creditor's perspective in mind.
- A plain-language fact sheet targeted to small business owners to make clear the implications, obligations and impacts of each type of external administration.
- In recognition of modern technology, communication should be electronic to mitigate time delays in postal services arising from geographical locality and remove the costs of producing multiple paper copies from the funds available to distribute to creditors.

- In arranging a meeting of creditors, the registered liquidator to facilitate remote attendance utilising video- and teleconferencing.

Proposal

Amendments to the framework to provide creditors with more powers were legislated in 2017 following the Senate Economics References Committee report, delivered in 2010, into *“The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework”*.⁹ The integrity of an insolvency process relies on creditors to exercise these powers.

In Issue 15 of the ASIC Corporate Insolvency Update, April 2020¹⁰, ASIC identified that a key failing of creditors’ reports was that the information was ‘generic, not company specific or customised, and creditors were unable to decide if the remuneration claimed was necessary or proper.’ ASIC further found that such generic reports meant ‘creditors lacked interest or motivation to vote’. One of the outcomes of the current system is that thousands of dollars is spent on producing, photocopying, and posting creditors information and lodging various forms with ASIC, funded from proceeds that should be distributed to creditors.

Based on the consultations for this report, as well as through assistance provided by this Office, early in the process of creditors’ meetings, unsecured creditors, the majority being small businesses, will be advised that they should expect no distribution from the administration. They will usually redirect their efforts to replacing the lost revenue. Even where a small business creditor remains engaged, the information contained in the various reports provided to creditors does not appear to provide any genuine insights to the activities of a registered liquidator.

Stories from a small business: Estimated versus actual cost (cont...)

In each Presentation of Accounts report, Form 524, lodged with ASIC the ‘Details of causes which may delay the termination of your appointment’ were noted as (reproduced in full):

May 2016 – November 2016 :

Recovery of remaining debtors; - Deal with secured creditor reporting and claims; - Convene and hold meeting of creditors; - Declare dividend to priority creditors; - Conclude on potential unfair preference claims; and - Attend to statutory obligations

November 2016 – May 2017:

Convene and hold meeting of creditors; - Conclude on potential unfair preference claims; and - Attend to statutory obligations

May 2017 – November 2017:

Recovery of voidable transactions; - Calculation of Superannuation Guarantee; - If sufficient funds, declare a priority dividend; - Attend to statutory obligations; and – Finalise

For November 2017 – May 2018:

Recovery of voidable transactions; - Calculation of Superannuation Guarantee; - Declare a priority dividend; - Attend to statutory obligations; and – Finalise

In Issue 9 of ASIC Corporate Insolvency Update, October 2018, ASIC noted to registered liquidators that ‘It is important to ensure that your audience knows how your time was spent and how that benefited creditors.’

⁹ https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Completed_inquiries/2008-10/liquidators_09/report/index

¹⁰ <https://asic.gov.au/about-asic/corporate-publications/newsletters/asic-corporate-insolvency-update/asic-corporate-insolvency-update-issue-15/>

Further, the Update noted ‘...reflections of creditor misunderstanding result(ed) from practitioners ... overreliance on precedent material.’

Given ASIC’s updates, the information provided to creditors is legalistic, generic rather than specific to the business under administration, expensive to produce, and overwhelming for creditors not familiar with the insolvency framework. This is especially true where the creditors are small businesses. As such, we recommend a standard, short format explanatory brief be created for all creditors, irrespective of ranking. Those creditors who wish to examine the full notes of the registered liquidator can access those as they see fit.

As the Government regulator, ASIC is best placed to develop plain-language fact sheets which discuss the likely legal implications and obligations of, and impact on, the owner, their business, and any directors of the business which undergoes one of the external administration processes. Registered liquidators should be required to provide the relevant fact sheet(s) when they are initially contacted by a small business, noting that these fact sheets will not prevent a registered liquidator from explaining the processes in their own language and using their own examples.

That the default method of communication during external administrations is by post, only compounds the difficulty for small business creditors to participate during external administrations. This disproportionately impacts creditors outside of metropolitan areas as, in many regional areas, the post may only be delivered one or twice a week. With only 7 days’ notice of creditors meetings required, relying on postal services can mean the notice with volumes of legalistic documents, may only be received on the day of the meeting.

Similarly, creditor’s meetings are to be held at a date, time, and place convenient to the majority, by value, of the creditors.¹¹ This ‘by value’ requirement results in meetings usually being held in capital cities as the highest value creditors of small businesses are most often banks or other lenders and the ATO. Creditors in regional and remote areas need to invest time away from their business to travel to a capital city, fund overnight accommodation, in order to attend a meeting that may only last a couple of hours. Given that teleconferencing and online meeting platforms have improved significantly in recent times and have been readily embraced during the COVID-19 pandemic it seems logical that accommodating attendance electronically at creditor’s meetings should be mandatory.

¹¹ Corporations Act 2001, No. 50, 2001 - SECT 497

Proactive and targeted handling of complaints

Recommendation 10: Better targeted investigation and recording of misconduct

- a) Where a Director's Information Number (DIN) record shows a director has been involved in three or more external administrations, or if there are more than three complaints about a director, over a rolling five-year period, ASIC must investigate the conduct of that director.
- b) The Australian Small Business and Family Enterprise Ombudsman (ASBFEO) should be designated a priority complainant under the *Corporations Act 2001 (Cth)*.
 - i. As a priority complainant, the ASBFEO would be empowered to substantiate serious complaints concerning practices of registered liquidators and office bearers.
 - ii. The ASBFEO will lodge a complaint with ASIC together with appropriate evidence.
 - iii. ASIC would be required to investigate the complaint and report its findings and proposed actions to the ASBFEO within 90 days.
- c) When an external administration uncovers possible misconduct by a director or a registered liquidator the cost of the investigation into that possible misconduct should be borne by ASIC.

Summary

- There has not historically been a formal mechanism to track office bearers and related parties as they close or open companies providing the same goods or services.
- The new Director's Identification Number register provides ASIC with an opportunity to track directors and the liquidations and complaints associated with that director
- The ASBFEO is uniquely placed to gather information from and on behalf of small businesses regarding the behaviour of both registered liquidators and the directors of companies undergoing liquidation

Proposal

Illegal phoenix activity has been estimated to be cost the Australian economy between \$1.8 - \$3.5 billion a year.¹² The costs translate to unpaid creditors, especially to small business, unpaid employee entitlements, and unpaid taxes. Businesses that phoenix gain an unfair competitive advantage to those that meet all their statutory obligations.

While ASIC holds the responsibility monitor compliance of directors to their statutory obligations and to regulate the practices of registered liquidators, investigations of alleged misconduct sits with external parties such as registered liquidators.

ASIC Report 645 shows that in the 7,498 initial external administrators reports received, registered liquidators identified possible misconduct in 6,638 (almost 90%).¹³ The most common misconducts identified were civil breaches (84%) such as acting in good faith, obligation to keep financial records and insolvent trading. However, there is no information on what action, if any, ASIC took to verify alleged misconduct and, if proven, discipline the director.

The burden of investigation currently rests with the registered liquidator who must conduct an initial investigation into the affairs of a business, drawing on the assets that can be realised to fund the process. While registered liquidators are best placed to undertake the initial investigation, this should not be funded from the remaining assets of business driven to insolvency by the misconduct of its owners.

¹² The Economic Impacts of Potential Illegal Phoenix Activity, pwc, July 2018, page iii

¹³ ASIC Report 645 - Insolvency statistics: External administrators' reports (July 2018 to June 2019), December 2019, page 21

ASIC should investigate and publish findings on all possible misconduct reported by registered liquidators. Where a finding of misconduct has been delivered against a director, that director must be tracked and barred from holding other director positions so long as there is outstanding action against any company of which they already hold a director position.

While registered liquidators report on the activities of directors, rarely do they report misconduct of their peers. The law requires external administrations to be completed efficiently and registered liquidators can be held accountable to the codes of conduct of the industry bodies of which they are a member. However, these industry bodies do not have the authority to deregister a registered liquidator or provide compensation to victims of misconduct.

Scenario 4: “Identifying illegal phoenix activity”

The initial investigations by the registered liquidator of Company ABC (name changed), placed into voluntary administration by its director, identified 10 businesses registered that had, or still, operated from the premises of Company ABC. Company ABC’s director was a director across all these businesses.

Significantly, other businesses in this group with the director of Company ABC as the sole director, had been liquidated owing significant amounts to the ATO including employee entitlements.

In addition to operating from the same premises as Company ABC, the other businesses had, and have, the same branding, the same website, and the same contact details.

Over time, two directors from the group of businesses have entered bankruptcy following the ATO filing a creditors petition. The registered liquidator of Company ABC held public examinations but was unsuccessful in identifying insolvent trading, breach of director’s duties or illegal phoenix activity.

The registered liquidator has now exhausted the resources of Company ABC, its creditors receiving zero return and the director continues to run the other businesses.

The number of regulatory activities undertaken by ASIC, in comparison to the number of external administrations each year, does not appear to be proportionate. Included in the activities undertaken by ASIC over July 2018 to June 2019¹⁴ were reviews of:

- 313 reports of alleged misconduct of a registered liquidator – which found in 83% of cases, there was insufficient evidence of, or no breach of, the Corporations Act.
- 55 transaction reviews – finding in 53% of cases insufficient concerns to warrant action by ASIC.
- 8 remuneration reports– finding 6 adequate and 2 inadequate.
- 502 annual liquidator returns – finding no issues in 78% of returns.
- 10 creditors’ meetings attended to better understand the conduct and practices of registered liquidators.

Similarly, the industry body representing registered liquidators, the Australian Restructuring Insolvency and Turnaround Associate (ARITA) notes in their 2019 annual report that of 34 complaints received during 2019, six cases were investigated either with the member directly or by the internal review panel, while no cases warranted any significant action.¹⁵ Of the six ‘concerns’ – a matter which comes to the attention of ARITA through a recorded judgement or other court documents, an announcement by a regulator, through the

¹⁴ ASIC Report 658 – ASIC regulation of registered liquidators: July 2018 to June 2019, April 2020, paragraphs 59, 90, 91, 100, 103, 106

¹⁵ Page 6, Annual Report 2019, Australian Restructuring Insolvency & Turnaround Association.

media, or through feedback of other members – which were considered in 2019, four were ongoing at the time of the release of the annual report, while only one resulted in the termination of membership. As noted above, ARITA has no power to deregister the liquidator in question.

This Office deals with many small businesses which are undergoing external administration, and we are well placed to recognise where registered liquidators may be providing advice or services which are not in the best interest of the creditors or the small business in question. This Office should be afforded a priority complainant status, to be enacted within the *Corporations Act 2001*, such that we can refer serious matters on to ASIC for their timely investigation and reporting of the outcome.

Be wary of untrustworthy advisers

Untrustworthy advisers prey on directors in your situation – don't pay good money for bad advice.

Some advisers contact directors whose businesses may be in financial distress. While not all of these advisers do the wrong thing, some recommend directors take actions which could be illegal. For example they may recommend transferring company assets into another company in order to continue operating – this is known as phoenixing. Actions like this can lead to serious consequences for directors, including large fines or even imprisonment.

Warning signs to watch out for

There are a number of warning signs that may indicate an adviser is not trustworthy, including:

- contacting you 'out of the blue' and making promises that sound too good to be true
- suggesting you transfer assets owned by your company into another company without paying for them
- reluctance to provide their advice in writing
- advising you to
 - destroy books and records or
 - withhold or delay providing them to the company's liquidator (if appointed)
- being unregistered or unlicensed by a recognised professional body or government agency
- suggesting you use a 'friendly' liquidator to wind up your company – by law a registered liquidator, if formally appointed to externally administer your company, cannot act for you personally or your adviser – they must be independent and comply with the obligations imposed on them under the Corporations Act.

How to protect yourself

If you are contacted by an adviser you should always be sure about the advice you are paying for. Ensure you:

- ask for any advice you receive to be provided in writing so you have a record of it
- check the professional credentials of any adviser.

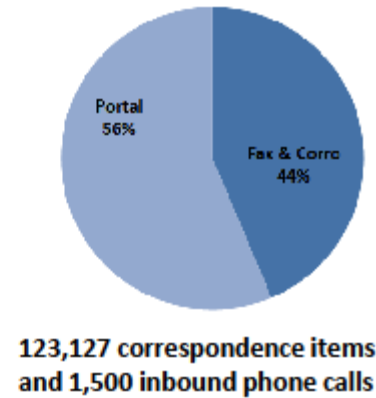
Some advisers target directors to offer 'friendly,' but bad advice. Taking this advice might result in you breaking the law or breaching your duties as a director. This can have severe consequences such as personal liability, large fines or even imprisonment.

The ATO is working with other government agencies through the Phoenix Taskforce to protect public revenue, businesses and employee entitlements by reducing and deterring illegal phoenix activity.

Appendix B: ATO insolvency profile

ATO Insolvency profile 2018/19 FY

Total insolvencies in Australia	The number of insolvencies where the ATO was a creditor	The number of insolvencies where the ATO initiated action
7,964 Corporate insolvencies	5,900 (74%)	1,219 (15%)
15,374 Personal insolvencies (bankruptcy)	4,484 (29%)	336 (2%)



Our Teams

The ATO has approximately 130 FTE managing insolvency work types



Inbound
Telephony



Complex
Insolvency



Case
Managers



Relationship Management

Preference
claims
(1,529)

Creditors
meetings
(11,286)

Account and
correspondence
processing



Consultations

Reference group members

Chair John Williams Former Senator for New South Wales

Company	Representative
Consumer advocate	Fiona Hawkins
Council of Small Business Australia	Elizabeth Skirving
Crouch Amirbeaggi Pty Ltd	Nicolas Crouch
Crouch Amirbeaggi Pty Ltd	Shabnam Amirbeaggi
Family Business Australia - A. H. Beard	Garry Beard
Financial Counselling Australia	Fiona Guthrie
Institute of Public Accountants	Vicki Stylianou
Matthews Folbigg	Stephen Mullette
Premier Litigation Funding Management	Douglas Whelan
Small Business Mentoring Service Incorporated	David Gregory

Insolvency sector

Organisation	Company
Academic	R Fisher, General Counsel at University of Sydney
Consultant	Tiernan White Consulting Pty Limited
Financial counsellor	Financial Counselling Australia
Financial counsellor	Rural Financial Counselling Service - NSW, QLD, VIC
Financial counsellor	Consumer Action Law Centre
Lawyer	Sewell & Kettle Pty Ltd
Practitioner	Australian Debt Solvers
Practitioner	BRI Ferrier Pty Ltd
Practitioner	Condon Associates Group
Practitioner	Heard, Phillips, Lieberenz
Practitioner	Franchise Accounting and Tax Pty Ltd
Practitioner	Hymans: Values & Auctioneers

Practitioner	Insolvency News Online
Practitioner	Litigation Funding Solutions
Practitioner	Lowé Lippmann
Practitioner	Mackay Goodwin
Practitioner	Murrays Legal
Practitioner	Smith Hancock
Practitioner	Macks Advisory
Roundtable	Committee for Gippsland

Government bodies

Commonwealth	Department / Regulator
Government	Attorney-General's Department: Fair Entitlements Guarantee
Government	Attorney-General's Department
Government	Australian Securities and Investments Commission
Government	Australian Financial Security Authority
Government	The Treasury

Industry Associations

Organisation	Company
Industry association	Association of Independent Insolvency Practitioners
Industry association	Australian Restructuring Insolvency and Turnaround Association
Industry association	Chartered Accountants Australia & New Zealand
Industry association	Franchise Council of Australia
Industry association	Turnaround Management Association Australia
Industry association	Master Grocers Association

Discussion Paper (December 2019)

Contributor

SM solvency Accountants

Chartered Accountants Australia and New Zealand

UNSW School of Business and Taxation

NSW Small Business Commissioer - NSW treasury

Victorian Farmers Federation

Law Council of Australia

UNSW Tax Clinic

Pitcher Partners

Financial Counselling Australia

Australian Restructuring Insolvency and Turnaround Association

Housing Industry Association

Australian Institute of Credit Management

Australian Credit Forum

Australian Securities and Investments Commission

Alyward Street Pty Ltd

National Farmers federation

International frameworks and comparisons

We have reviewed a number of insolvency frameworks from countries that function under a similar justice system to Australia. In particular, we have considered pre-pack administrations available in the United Kingdom (UK) and Chapter 11 Bankruptcy in the United States of America (USA).

There are two significant differences between the Australian framework and comparable jurisdictions. First, in international jurisdictions, there is one system for insolvency where directors of corporations and individuals have the same opportunities to manage financial stress when they are unable to pay debts as they fall due. In Australia, individuals and companies operate in separate frameworks, with the Australian Financial Security Authority (AFSA) managing application of the bankruptcy and personal property securities laws and the Australian Securities and Investments Commission (ASIC) administering the *Australian Securities and Investments Commission Act 2001* (ASIC Act) and the *Corporations Act 2001* (Cth).

On face value, there appears to be little to no benefits for creditors or individuals in separate frameworks as often, particularly for small businesses, personal assets and personal guarantees are the foundations of the business.

Secondly, in international examples, the court system plays a key role in monitoring the person or business working through insolvency, where that is not the case in Australia.

The United Kingdom

The insolvency framework in the United Kingdom (UK) aims to restructure and maximise the economic benefits of preserving the heart of a viable business, with a particular focus on retaining jobs. The key difference to the Australian framework is that registered liquidators in the UK can assist in the pre-sale negotiations and then continue to either restructure or wind-up the company through a formal process.

From a legislative perspective, the *Insolvency Act 1986* (UK) sets the insolvency framework while the *Enterprise Act 2002* (UK) (*EA 2002*) sets the administrative processes. The UK market has developed a pre-packaged administration in line with the goals of the EA 2002, although it is not expressly covered by legislation.

Pre-packaged administrations

Known simply as pre-packs, the process allows the sale of part or all of a business and its assets, negotiated with the oversight of a registered liquidator, before entering a formal external administration. Once negotiations are complete, the registered liquidator is formally appointed to execute the sale and commence the administration.

The intended purpose of a pre-pack is to realise the sale of assets quickly, with minimal costs, and to maintain a brand or a business's reputation. The requirement for the oversight of a registered liquidator is to give confidence to creditors that the sale was at market value.

There have been significant debates as to the effectiveness of pre-packs as the majority of sales are to the incumbent directors or owners raising claims that it facilitates illegal phoenix activity.

As pre-packs are conducted outside the formal external administration process, the regulator has not captured detailed statistics of their use, success, or failure. In 2009 a form known as an SIP16 was introduced to be completed by the registered liquidator, provided to creditors, and lodged with The

Insolvency Service, an executive service within the UK's Department for Business, Energy, and Industrial Strategy. The SIP16 provides details on the factors considered in reaching the decision to undertake a pre-pack.

Pre-pack review

A review of pre-packs was announced in July 2013, with a final report delivered in June 2014. 500 pre-packs from the 2010 calendar year were reviewed, amounting to about two-thirds of the total number of pre-packs in any given year.

The final report concluded that while pre-packs had delivered some benefits, the framework required reform and made six recommendations. These have been implemented through a variety of measures which include:

- creation of the Pre-pack Pool Limited, a group of experienced and independent businesspeople tasked with providing an opinion on a proposed sale where the buyer was a connected party.
- placing a requirement on any connected party to complete a 12-month viability review of the proposed 'new' company.
- adding requirements to the SIP16 strengthening the process of valuations and marketing.
- monitoring of the SIP16s is now carried out by industry bodies, five of which have been nominated and are known as Recognised Professional Bodies.¹⁶

Review of the implemented changes

We consulted with insolvency bodies in the UK including the Pre-pack Pool Limited and Insolvency Support Services Ltd, a body providing support to insolvency profession and practitioners. Collectively they considered that:

- the redrafted SIP16 is not increasing transparency for creditors as, while the template outlines what should be included, each practitioner can use their own format.
- where a particular format of a SIP16 is found to satisfy creditors, that format is shared and adopted by other practitioners as best practice until the next iteration.
- the data held by the Pre-Pack Pool Limited indicated that its service to provide an independent opinion was not being utilised. From 241 connected party sales in 2018 (from a total of 450 SIP-16s lodged) only 24 sought the opinion of the pool.

It is noted that the framework in the UK is debtor-friendly with the aim to minimise the economic impact of financial stress and enable viable small businesses to restructure. The primary concern is the opaque nature of pre-packaged administrations.

The United States of America

In the United States of America (USA) a person or business can file for bankruptcy and in doing so, seek to either discard their debts under Chapter 7 (liquidate), Chapter 13 (reorganise and repay) or Chapter 11 (modify debt and reorganise). Bankruptcy is overseen by federal courts in accordance with the *United States Bankruptcy Code 2019 Edition*.

¹⁶ The Insolvency Service, 2017 Annual Review of Insolvency Practitioner Regulation, May 2018, page 3

Of the 772,646 bankruptcies filed between 31 March 2018 – 31 March 2019, 62% were filed under Chapter 7, 37% under Chapter 13 and less than 1% under Chapter 11.¹⁷

Of the 772,646 cases nationally, 2.9% were filed by businesses. Where a business had filed, 64% were under Chapter 7, 26% under Chapter 11 and 8% under Chapter 13.

Chapter 7

Access to Chapter 7 is means tested which requires a persons' median income to be less than their state's median income. A trustee liquidates assets and uses the proceeds to pay creditors. For individuals, once assets are sold and proceeds distributed to creditors, any remaining debt is discharged.

While a discharge is not available for partnerships or corporations, and the process liquidates assets, the statistics indicate this is the preferred course for businesses to file for bankruptcy.

Chapter 13

Access to Chapter 13 is limited to those with secured debt of less than US\$1,184,200, unsecured debt less than US\$394,725 and high enough income to support a repayment plan to pay off all debts¹⁸. The repayment plan must propose to satisfy creditors over three to five years. This is the least used avenue by businesses.

Chapter 11

Only 26% of businesses filed under Chapter 11, however, businesses make up around 70% of all Chapter 11 filings. Under Chapter 11 provisions, a business can negotiate with its creditors to pay back a portion of their debt. For example, a business may offer to pay back the creditor a rate of 70 cents in the dollar against the amount owed. It is up to each creditor to accept or decline an offer and to choose if they will continue to trade with the business.

A key difference to the Australian framework is that the company that files, known as the debtor in possession, continues to run the business. While perceived as a benefit, it places onerous reporting requirements on the owner. These include 'accounting for property, examining and objecting to claims, and filing informational reports as required by the court and the U.S. trustee'¹⁹. Approval of the courts must be sought for major decisions such as the sale of assets, entering into or breaking a lease, secured financing arrangements, and shutting down or expanding business operations.

Within Chapter 11 there is consideration of a small business case. This requires the business to be engaged in a commercial business or activity with total debts of US\$2,566,050 or less. Similar reporting requirements apply but there is no creditor committee. A Small Business Debtor must make ongoing filings, and pay the relevant fee, to the court concerning its profitability and projected cash flow.

The US framework appears debtor friendly yet the majority of businesses file under Chapter 7 which will result in assets being liquidated.

¹⁷ Major Bankruptcy Types Explained – with Statistics, David M Offen Esq, 19 August 2019, online

¹⁸ What is the Chapter 13 Means Test?, Cornwell Law Firm, accessed 30 June 2020

¹⁹ <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics>, accessed 10 June 2020

Europe

Members of the European Union have driven significant change in their insolvency laws in recent years. The focus of these changes has been

“...that the debtor stays in possession. The debtor's incentive is not simply that the restructuring is successful but that the debtor (its shareholders) will have a stake in the restructured company... the directors with supposedly the best information and ability to influence the restructuring will have a chance to stay on board”²⁰

France

France defines insolvency as a corporation that is unable to meet its (currently) due debts with its (immediately) available assets.²¹ Reforms have focussed on providing pathways for businesses that monitor their finances to act early to find a remedy to rising financial difficulties.

Where a business is solvent and experiencing financial difficulties, two procedures are available to restructure the debtor business and prevent insolvency:

ad hoc mandate, where a debtor company negotiates a confidential rescue with creditors under a court appointed agent; and

Conciliation, where a court appointed conciliator suggests a proposal and may arrange a pre-packaged sale of a business. When agreement is reached, the debtor can request a formal court approval, which is published, or a simple acknowledgement which is not published.

Where a business is solvent but facing difficulties it cannot overcome, it can open safeguard proceedings. This seeks the court to supervise a restructure to prevent insolvency. If the business becomes insolvent after commencing safeguard proceedings, the court orders will convert to a formal insolvency.

Where a business is insolvent from a cash flow standpoint it must file for rehabilitation or liquidation within 45 days from becoming insolvent. Rehabilitation aims to arrive at a rehabilitation plan or, where rehabilitation appears impossible, liquidation.

Liquidation proceedings last until the liquidator expects no more proceeds or after two years when a creditor can request the court to wind up the proceedings. A simplified form is available for small businesses which last for a maximum of one year. “Small businesses” are defined as those with fewer than 50 employees and annual turnover under €3m (approx. AUD\$5m).

An evaluation of types of insolvency published in March 2017 found that

‘Despite the existence of strong safeguard procedures and acquired support in reorganization, French statistics of 2015 shows, that only 1.533 (2.4%) of companies during financial problems used safeguard procedures and 18.370 (29.1%) used reorganization tool, while other 43,178 (68.5%) companies came to liquidation after suffering financial crisis.’²²

²⁰ Wiley, The European Union preventative restructuring framework, D C Ehmke et al, Revised 31 January 2019, page 206

²¹ Sourced on 24 April 2020, <http://www.triplet.com/company-law/french-insolvency-law/>

²² Santalova, Marianna et al. 2017. Evaluation of types of insolvency systems in Russia, Germany, and France. *Journal of Advanced Research in Law and Economics*, Volume VIII, Spring, 1(23): 204 – 210.

Germany

Germany defines insolvency as (i) the inability to pay the due obligations or (ii) the over indebtedness, only for legal entities.²³ The main aim of the insolvency processes is the return of creditors' claims, not rehabilitation of the debtor. Proceedings can commence following default against any debt, there is no minimum value.

If a business is deemed insolvent, it has 21 days to return to solvency. During such time, creditors can appoint auditors to investigate the business, identify major problems and take actions such as decreasing costs or inventory levels. If solvency is not regained, then the business is obliged to make a bankruptcy application to the court or face criminal prosecution.

After the application to court, a debt must be proven under the neutral procedure of the court. If no debt is proven, then the debtor and creditor can work a way forward outside of court participation. If a debt is proven, then the court will start the bankruptcy process and appoint an insolvency practitioner who takes control of the company's assets.

While the debtor can apply for a debtor-in-possession procedure, in practice 'the vast majority of insolvency procedures—especially for smaller debtors—remain to be administered by an insolvency practitioner.'²⁴

A creditors meeting is held to choose the solution for the business. This must be done within 45 days after the start of the bankruptcy proceedings.

There are three options:

- Liquidation, where the assets are sold or auctioned and creditors are proportionally repaid out of receipts.
- Reorganisation, where the company continues to exist and creditors receive payments from company's profits. The plan to restructure has to be submitted to the court within three months.
- Sale, where a company is sold with creditors receiving payment from the proceeds.

The framework in Germany is creditor friendly as, unlike France, there are no safeguard procedures and the time to develop a plan to restructure is short, only three months.

²³ Sourced on 24 April 2020,

https://www.justiz.nrw.de/WebPortal_en/projects/ieei/documents/public_papers/german_insolvency.pdf

²⁴ Wiley, The European Union preventative restructuring framework, D C Ehmke et al, Revised 31 January 2019, page 195



Australian Government



Australian
Small Business and
Family Enterprise
Ombudsman