Insolvency Law
Bulletin

Australian Insolvency Law Reform for Small Business — Janus-Faced?

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On 24 September 2020, in a surprise but welcomed move, the Federal Government announced a new debt restructuring procedure for small businesses with liabilities of less than AUD$1 million.[1]

This watershed reform expressly recognises that the current insolvency system in Australia based on a one-size-fits all system, regardless of size and complexity, is inappropriate for all companies.[2] It reflects the reality that Australia is a nation of small businesses — the engine room of the economy.[3]

The proposed reform readily concedes that there are reduced opportunities for companies in the SME sector to restructure and survive. It acknowledges the need for an efficient external administration process that encourages a better deal for creditors and employees.[4] Small businesses are a significant generator of employment, with 2.2 million people employed.[5] The reforms are aimed at achieving "greater economic dynamism"[6] in helping more small businesses to survive. These reasons are the leitmotiv for a new insolvency framework.

The promise of a new flexible approach to meet the needs of small businesses is a positive and long overdue step. It seeks to allow for such companies to trade on or to shut down their business with greater speed than currently is the case, under the supervision of a small business restructuring practitioner (SBRP). With proper design principles, the new law has great potential to offer a life-line for small distressed companies and be a game-changer in the administration of insolvency law for this key sector of the economy.

On 7 October 2020, the announcement was swiftly followed by the release of an exposure draft legislation and explanatory materials for public comment.[7] The Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 (Cth) (the draft Bill) will introduce a new Pt 5.3B of the Corporations Act 2001 (Cth) to establish a debt restructuring process for eligible small companies.[8]

However, before the ink was dry, public submissions closed on 12 October 2020 — less than a week since the large draft legislation first saw daylight. Subject to its passage in parliament, measures in the draft Bill are anticipated to come into effect on 1 January 2021.

Significantly, and unsurprisingly due to the hasty steps taken by the government, the draft Bill raises more questions than answers and appears to be Janus-faced[9] where some of the key content does not appear to match the government's rhetoric. These points are expanded on below, after a brief discussion on the catalyst for the current corporate insolvency reform and a brief overview of its key features.

Catalyst for Law Reform

The law reform proposal can be seen as a bold, pre-emptive and pragmatic move to deal with a looming insolvency crisis arising from the coronavirus pandemic.

Due to the impact of COVID-19 on the economy, an insolvency "tsunami" is widely predicted.[10] The government's economic stimulus activities, such as JobKeeper, is generally seen as prolonging the inevitable and successfully masking a ticking financial time-bomb — the widespread collapse of companies starved of adequate cash flow, the lifeblood of business.[11]

Thousands of companies are expected to hit the wall upon the lifting of the temporary suspension of the insolvent trading law on 31 December 2020.[12] The Government, in its law reform effort, appears to be attuned to the deafening beat of many distressed companies marching steadily towards the financial cliff.

It is feared that an army of zombie companies are being kept artificially afloat through government financial support.[13] These are businesses who carry debt beyond their overall value and with no hope of salvage. Without a lifeline in the form of a new debt restructuring procedure, an avalanche of corporate insolvencies can be expected after the end of December 2020,[14] with devastating consequences for individuals, families and communities.

The timing of the law reform proposal suggests a massive bottleneck is expected from the insolvency crisis about to hit the economy in 2021. The law reform is designed, in part, to hasten the burying of dead companies with greater speed and efficiency than the current system. This proposed improvement in the legal framework is a positive feature.

The proposed law reform may be seen as a tacit admission of the failure of the safe harbour law reform introduced by the government in September 2017.[15] This reform excused breach of insolvent trading law for directors who engaged in a course of action reasonably likely to lead to a better outcome for a company in financial trouble than an immediate liquidation or administration.

Anecdotal evidence by insolvency practitioners suggests the safe harbour reform is largely shunned in the SME sector as it is not seen as fit for purpose.[16] Unlike the operation of the safe harbour, the draft Bill will put a cap on the fee of the small business restructuring practitioner. This is likely to overcome the defect in the safe harbour regime, seen as expensive for companies in the SME sector, and perhaps will help incentivise the use of the new debt restructuring procedure.

Draft Exposure: Key Features

The object of the new Pt 5.3B is to provide for a restructuring process for eligible companies[17] that allows the companies to:[18]

- retain control of the business, property and affairs while developing a plan to restructure their debt with the assistance of a small business practitioner; and
- enter into a restructuring plan with creditors.

While a company is under the restructuring process, the company directors retain control of the company's business, property, affairs and are responsible for ensuring compliance with the new legal regime (new ss 453K and 453L). Significantly, for the first time, directors in eligible small companies will be able to do trade their way out of financial difficulty without the need to appoint an external administrator to take temporary control of the business. The proposed change in law is intended to result in a "debtor in possession" model of insolvency law. It signals a fundamental change from the current "creditor in possession" model.

An independent SBRP, representing a new class of registered liquidator with qualification details still to be worked out, is given a key role under the new law.[19] They are expected to help the directors to develop a rescue plan and are excepted to assess the continued viability of the business. A corporate rescue outcome will represent a fundamental shift from the traditional legal approach which generally has a heavy focus on stigmatising and penalising business failure. In contrast, the new debt restructuring procedure has potential to incentivise corporate rescue and to prevent unnecessary destruction of valuable and viable businesses in the SME sector.

If, however, the rescue plan is voted down, the company will be liquidated under a new streamlined process.

During the entire process restructuring process, the law will offer directors valuable breathing space. Legal action against the company by suppliers, lenders and other creditors to enforce payment of debts owed to them will be temporary suspended, akin to the equivalent provisions in Pt 5.3A.

Assessment

The discussion below offers critical comment on some aspects of the design principles underpinning the new Pt 5.3B of the Corporations Act — namely, the potentially restrictive liability cap for small business, the unusual features of the proposed debtor in possession model and the questionable claim of achieving the policy objective of an overall reduction in complexity and costs.

Eligibility of a small business

As part of the eligibility criteria for a small business to rely upon the new debt restructuring procedure, the liabilities of the company will be a critical factor. The maximum amount of liabilities, and the manner in which it is to be calculated, is yet to be announced in the regulations. The Treasurer, however, has publicly announced a liability cap of $1 million.[20]

If implemented, it raises a concern that this cap is likely to be small and may not sufficiently accommodate any future changes in the economy. Economies are never static and, as noted by the Productivity Commission, "macroeconomic conditions and population changes, along with broader government policy settings that influence the business cycle, can have an overarching influence on business set-ups, transfers and closures".[21] This is reason enough to have a higher figure.

Furthermore, the proposed liability cap bears little or no relationship to the manner in which the government has defined small business in other relevant contexts, for example for purposes of tax concessions and for financial reporting.

In the context of accessing small business entity concessions, the ATO defines a small business as a sole trader, partnership, company or trust that has an annual turnover (excluding GST) of less than $10 million.[22] Previously, prior to 1 July 2016, the turnover threshold was $2 million. In the context of exemptions from the need to prepare financial statements, s 45A of the Corporations Act defines "small proprietary companies" (as amended in 2019) as companies with at least two out of the following three characteristics:

- An annual revenue of less than $50 million (previously $25 million)

- Fewer than 100 employees at the end of the financial year (previously 50)
- Consolidated gross assets of less than $25 at the end of the financial year (previously 12.5 million).

Viewed in this context, the proposed liability cap appears to be low and should be reconsidered.

Against the ATO definition of a small business, small businesses account for 98.45% of all Australian businesses.[23] In 2013, 36% of small businesses had a turnover of $200,000 to less than $2 million with a slight decrease in 2016 to 34%, based on a 10,000 dataset of small businesses.[24] Notwithstanding that more than half of Australian businesses have a turnover of less than $200,000,[25] the figures suggest there may be a prima facie case to re-examine the current amount set for the total liabilities of a company seeking to enter the debt restructuring process.[26]

The proposed liability cap appears to be incongruous with the legal treatment of a small business for other purposes of commercial law.[27] Increasing the liabilities threshold to a higher amount, not necessarily to the same high thresholds under tax law and the Corporations Act discussed above, is likely to broaden the reach of the new law. It will significantly increase the chances of achieving the goals in s 452A which underpins the new Pt 5.3B of the Corporations Act and the aspirational aim of achieving "greater economic dynamism" in helping more small businesses to survive. Concerns about illegal phoenixing are legitimate, and are addressed under the draft legislation. It will also be incumbent upon the SBRP is act as gatekeeper against such abuse.

Finally, international comparisons show the proposed figure of $1 million will be significantly out of step with international practices, such as in the United States and in Singapore. Access to the equivalent laws in the US (Chapter 11) requires an incorporated small business to have debts of less than US$2,725,625 after end of 27 March 2021 (currently temporarily raised to US$7.5 million)[28] and, for companies in Singapore, less than SG$2 million to enable access to the new streamlined process for insolvency.[29] Our laws, in this respect, should be competitive with the restructuring laws in other key foreign jurisdictions.

Debtor in Possession Model

The proposed debtor in possession model is akin to the Chapter 11 bankruptcy model used in the United States, but with at least two key differences. Unlike the Australian proposal, access to Chapter 11 is not limited to companies with debts less than $1 million, evidenced above. Unlike the position in the US, the court is not given a central role, nor oversight function, in the new debt restructuring process in Australia.

The Janus-faced features of the proposed new law are most apparent when the role and functions conferred on the SBRP are considered. The new s 453E(1) confers an advisory role on the SBRP where they are expected to provide advice to the company to ensure that it meets the requirements of the debt restructuring process. This includes assisting the company in the preparation of the restructuring plan and making a declaration to creditors in relation to the proposed plan.

But the law reform goes well beyond conferring an advisory role on the SBRP. It also expects the SBRP to have a deliberative role where a variety of consents is required from them — such as consenting to the company entering into a transaction outside the ordinary course of business and consenting to the enforcement of ipso facto rights (new ss 453L(2) and 454P(7)). Furthermore, the SBRP is taken to be a company's agent (new s 453H).

It is difficult to reconcile the deliberative role expected of the SBRP when it is claimed by the government that a debtor in possession model will operate. If the latter prevails, query the need for the SBRP to be acting as the company's agent.

The Draft Bill indicates that s 9 of the Corporations Act will be amended to include the SBRP as an officer of the company. Consequently, all of the directors' and officers' duties under ss 180–183 (duty of care and diligence; to act with honesty and proper purpose and to avoid conflicts of interest), together with the accompanying civil and criminal liabilities for breach will apply. It is therefore important for the new law to clearly spell out the duties expected of the SBRP. Section 453E lists basic duties to advise the company and assist in preparing a restructuring plan to be put to the creditors but the further detail is left to the regulations, including their powers and their rights and liabilities. Only some sections expressly direct the SBRP to consider creditor interests when making particular decisions (new ss 453J(1) and 453L(5)). This regulatory gap leaves the SBRP vulnerable to potential civil and criminal liability for breach of officers' duties.

Legislative Maze

The government's penchant for "clutter and complexity"[30] and law making through regulations continues unabated. Failure to fully address key substantive points, such as the eligibility criteria to use the restructuring process, together with the qualifications and duties of the SBRP, means that the regulations are expected to do the heavy lifting to make fuller sense of the new insolvency regime.[31] Consistent with recent practices, a regulatory morass can be anticipated which has potential to undermine the policy goals of the new law.

Instead of starting afresh, with a root and branch review of the operation of voluntary administration upon which large parts of the new Pt 5.3B is modelled, the government has fallen into the trap of path dependency.[32] By its own admission, the government noted in the explanatory materials to the Draft Bill:[33]

> The new debt restructuring process draws heavily on the established voluntary administration framework in Part 5.3A of the Corporations Act and shares many of its features . . .

It begs the question as to why the new Pt 5.3B is modelled on a law that admittedly suffers from the following defects candidly acknowledged by the government?[34]

> The current insolvency system is a one-size-fits-all system that imposes the same duties and obligations . . . the current system lacks the flexibility to provide for small businesses for which complex, lengthy and rigid procedures can be unsuitable. The barriers of high cost and lengthy processes can prevent distressed small businesses from engaging with the insolvency system early . . .

For sure, the government has introduced modifications to try and accommodate the specific needs of small businesses, but it cannot be said to have done so in a consistent and coherent manner. For example, as noted in many public submissions,[35] the government's failure to address the widespread use of trading trusts has potential to undermine the effectiveness of both the proposed debt structuring and the streamlined liquidation process. It is anticipated that many small insolvencies will continue to require expensive court intervention.

It is regrettable that the government did not adequately seize a unique opportunity to fashion a new insolvency regime, *sui generis*, to fully accommodate the specific needs of small businesses. Instead, the end-user (small business community) is likely to be required to navigate a complex and opaque law that is currently drafted in a way that is not easily accessible nor easily digestible. Some core provisions, such as the eligibility criteria for use of the new restructuring law or the qualifications of the SBRP, will not be found in the primary legislation.

Neither Fish nor Fowl

It is regrettable that the fast-tracked reform process of such magnitude has not allowed proper opportunities for deep consultation. Nor was there any attempt by the government to consider the flow on effects of the Draft Bill and its potential impact on bankruptcy law, given that many small businesses have their debts secured by directors' personal guarantees. The rushed process carries a heavier risk of sub-optimal law reform.

It is hoped that Australia does not end up with a new insolvency legal framework that reflects the current proposals which, in essence, are neither fish nor fowl. They are largely modelled on the complex provisions of voluntary administration, with a trim here and there, and re-engineered as a saviour for small business.

The proposals could do with further trimming to reflect the more common scenarios that can be easily anticipated when dealing with small business. To illustrate, related party creditor transactions can generally be expected to be more prevalent in a small business setting. If so, query the utility of the current provisions which expect court action to be made to challenge voting by related party creditors. This often entails delays and added costs. An expedient solution, consistent with the underlying policy objectives of the reform proposals, would be simply to exclude any related party creditor votes.

The risks to insolvency law reform without paying sufficient attention to adopting a holistic approach are well documented. The warning sounded by Professor Fletcher to the approach adopted to UK insolvency law reform a few decades earlier [1986–2003] are apposite:[36]

> Piecemeal tinkering with the machinery of insolvency law may perhaps fall short of altering the core values on which the entire system is built, but may nevertheless give rise to unintentional, unwelcome consequences.

Similarly, turning to the piecemeal approach favoured by the government to insolvency law reform in Australia, Professor Harris made the following critical remarks which bears repeating:[37]

> I can't help bemoan the lack of big picture reform. Other jurisdictions are introducing new regimes, considering debtor in possession procedures . . . We should be asking the fundamental question of what we want out of a 21st century insolvency and restructuring legal framework?

It is questionable whether the current reform will simplify the law and reduce costs to the extent claimed. On current evidence, such claims made in the explanatory materials appear to be cosmetic and overstated. The ultimate proof, however, is likely to be found in the complex regulations accompanying the new Pt 5.3B of the Corporations Act.

We await the next instalment to the package of reforms to the Australian insolvency framework. To guard against the prospect of the government letting a good crisis go to waste, it will be desirable for the government to commit to a root and branch review[38] of the operation of the new Pt 5.3B at least 12 months after its implementation.

Should the evidence call for fundamental reform, it is hoped that the government will commit to a sui generis legislative effort, fit for purpose, than rely on the current modest effort modelled heavily on rebadged parts of Pt 5.3A.

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Footnotes

1. Joint Media Release Josh Frydenburg with Michael Sukkar "Insolvency reforms to support small business recovery" (24 September 2020), https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/insolvency.
2. Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 Exposure Draft Explanatory Materials at p 6, https://treasury.gov.au/consultation/c2020-118203.
3. Australian Small Business and Family Enterprise Ombudsman, Small Business Counts — Small business in the Australian Economy (July 2019) at p 4, www.asbfeo.gov.au/sites/default/files/documents/ASBFEO-small-business-counts2019.pdf.
4. Above n 2.
5. Above n 3, at p 7.
6. Above n 2, at p 6.
7. Ibid.
8. The eligibility criteria for entering into the debt restructuring process are spelt out in Schedule 1, item 1, ss 453B(2) and 453C of the draft Bill. These include, *inter alia*, safeguards against illegal phoenixing activity or other forms of director misconduct. The new law is also unavailable to a company if it is already under restructuring or administration, has executed a deed of company arrangement that has not yet terminated, or where a liquidator or provisional liquidator has been appointed to the company.
9. Definition of *Janus-faced*: having two contrasting aspects especially: duplicitous, two-faced; www.merriam-webster.com/dictionary/Janus-faced.
10. Australian Small Business Family Enterprise Ombudsman "Fix broken system before 'insolvency tsunami' hits: Ombudsman" (21 July 2020), www.asbfeo.gov.au/news/news-articles/fix-broken-system-%E2%80%98insolvency-tsunami%E2%80%99-hits-ombudsman; A Hargovan "We're facing an insolvency tsunami. With luck, these changes will avert the worst of it" *The Conversation* (28 September 2020), https://theconversation.com/were-facing-an-insolvency-tsunami-with-luck-these-changes-will-avert-the-worst-of-it-146833.
11. E Alberici "Coronavirus stimulus measures like JobKeeper are keeping zombie businesses alive, warn insolvency practitioners" *ABC News* (24 July 2020), www.abc.net.au/news/2020-07-24/the-coronavirus-crisis-may-be-keeping-zombie-businesses-alive/12485528.
12. Section 588GAAA, contained in Schedule 12 to the Coronavirus Economic Response Package Omnibus Act 2020 (Cth), suspends the operation of the civil penalty provision in s 588G(2) for the duration. See further: M Murray and J Harris "Managing the Insolvency Curve in Australia" *Oxford Business Law Blog* (20 April 2020), www.law.ox.ac.uk/business-law-blog/blog/2020/04/managing-insolvency-curve-australia; A Hargovan, "What changes in insolvency laws mean for company directors" *Businessthink* (28 April 2020), www.businessthink.unsw.edu.au/articles/solvency-concerns-coronavirus-pandemic-company-directors.
13. S Atkins and K Luck "The new pandemic: Zombie companies will eat Australia's COVID-19 economic recovery" *Norton Rose Fulbright* (May 2020), www.nortonrosefulbright.com/en-au/knowledge/publications/063e1f78/zombie-companies-will-eat-australias-covid-19-economic-recovery; M Cranston "Late payments spike, zombies on the rise" *Australian Financial Review* (9 September 2020), www.afr.com/policy/economy/late-payments-spike-zombies-on-the-rise-20200909-p55tsr.
14. M Cranston "'Avalanche' of insolvencies will force law change" *Australian Financial Review* (22 May 2020), www.afr.com/policy/economy/insolvency-law-to-be-changed-as-avalanche-expected-20200322-p54con.
15. See further, A Hargovan "Governance in Financially Troubled Companies: Australian Law Reform Proposals" (2016) 34 *Company and Securities Law Journal* 483; J Harris, "Reforming Insolvent Trading to Encourage Restructuring: Safe Harbour or Sleepy Hollows?" (2016) 27 *Journal of Banking and Finance Law and Practice* 294.
16. P Hanrahan and A Hargovan "The COVID-19 safe harbour: a shelter in the storm for directors?" *Businessthink* (28 July 2020), www.businessthink.unsw.edu.au/articles/covid-19-safe-harbour-directors.
17. See n 8.
18. Schedule 1, item 1, 452A of the draft Bill.
19. Independence criteria and declaration process are spelt out in the new ss 456C; 453D of the Corporations Act. The removal and replacement provisions for the SBRP are found in the new ss 456E and 456F.
20. Joint Media Release Josh Frydenburg with Michael Sukkar "Insolvency reforms to support small business recovery" (24 September 2020), https://ministers.treasury gov.au/ministers/josh-frydenberg-2018/media-releases/insolvency.
21. Productivity Commission, Business Set-Up, Transfer and Closure Report (December 2015), at p 58 www.pc.gov.au/inquiries/completed/business/report.
22. www.ato.gov.au/business/small-business-entity-concessions/.
23. Australian Small Business and Family Enterprise Ombudsman, Small Business Counts — Small business in the Australian Economy (July 2019) at p 8, www.asbfeo.gov.au/sites/default/files/documents/ASBFEO-small-business-counts2019.pdf.
24. Ibid, at 22.
25. Ibid, at 8.
26. Schedule 1, item 1, s 453C of the Corporations Act recognises that the threshold amount prescribed in regulations is amenable to change.

27. Compare ARITA's submission which takes the opposite view and has called for a lower cap of $250,000, www.arita.com.au/ARITA/News/Submissions/Submission__Insolvency_reforms_to_support_small_business__.aspx.
28. Nelson Mullins Riley & Scarborough LLP "The Small Business Reorganization Act: An Unintended Lifeline For Small Businesses Considering Restructuring Due to COVID-19" *Lexology* (24 August 2020), www.lexology.com/library/detail.aspx?g=f93d7c38-4cbf-4140-be4b-e16b5885ca52.
29. Insolvency, Restructuring and Dissolution (Amendment) Bill 2020 (first reading 5 October 2020) www.parliament.gov.sg/docs/default-source/default-document-library/insolvency-restructing-and-dissolution-(amendment)-bill-36-2020 pdf; www.mlaw.gov.sg/news/press-releases/simplified-insolvency-programme.
30. C Jordan "Unlovely and Unloved: Corporate Law Reform's Progeny" (2009) 33 *Melbourne University Law Review* 626 at 635.
31. Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 Exposure Draft Explanatory Materials at [1.134]–[1.136]; https://treasury.gov.au/consultation/c2020-118203.
32. See further: L R Bebchuk and M J Roe "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 *Stanford Law Review* 127.
33. Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 Exposure Draft Explanatory Materials at [1.7 and [1.12]; https://treasury.gov.au/consultation/c2020-118203.
34. Ibid, at p 6.
35. For example, see submission by ARITA, www.arita.com.au/ARITA/News/Submissions/Submission__Insolvency_reforms_to_support_small_business__.aspx.
36. I Fletcher "The Law of Insolvency" (Sweet and Maxwell, 4th edn, 2009) 1-045.
37. J Harris (editorial) (2016) 17(9–10) *INSLB* 166.
38. For a similar call, see ARITA's submission, www.arita.com.au/ARITA/News/Submissions/Submission__Insolvency_reforms_to_support_small_business__.aspx.