24 January 2020

Law Council
OF AUSTRALIA

Business Law Section

Australian Small Business and Family Enterprise Ombudsman
GPO Box 1791
CANBERRA ACT 2601

By email: inquiries@asbfeo.gov.au

Dear Sir/Madam

Insolvency Practices Inquiry Discussion Paper

The Insolvency & Reconstruction Law Committee together with the SME Committee of the Business Law Section of the Law Council of Australia (the **Committees**) appreciate the opportunity to respond to the questions raised in the Insolvency Practices Inquiry Discussion Paper (**Discussion Paper**).

The Committees are two of the fourteen specialist committees established within the Business Law Section to offer technical advice on different areas of law affecting business. Each of these Committees approach issues of law reform and practice from a different perspective, which reflects their respective primary focus.

1. At the initial consultation with a registered liquidator, should the registered liquidator be required to provide a small business with:
a. a hard copy plain language fact sheet that outlines the various types of external administration and the role of directors and owners in each?
b. the reasons for recommending a particular course of action to the directors?

The Committees agree that a registered liquidator should be required to provide a small business with:
(a) a hard copy plain language fact sheet that outlines the various types of external administration and the role of directors and owners in each; and
(b) the reasons for recommending a particular course of action to the directors.

As noted on page 14 of the Discussion Paper, small business owners will unfortunately often seek advice from unlicensed and unregulated pre-insolvency advisers before seeking advice from a registered liquidator. If the advice received is to move assets to avoid paying their debts and then place the company into liquidation (which is often the case), the registered liquidator will not have the opportunity of considering and recommending any course of action other than liquidation and so the provision of such a fact sheet will have less value.

This question is related to question 9. Question 9 asks a similar question, but is directed to when a business seeks advice when facing financial difficulty, which could be from a person other than a registered liquidator (such as an unlicensed and unregulated pre-insolvency adviser). The Committees agree that any person that provides such advice should be required to provide the small business with:
(a) a hard copy plain language fact sheet that outlines the various types of external administration available and the role of directors and owners in each; and
(b) the reasons for recommending a particular course of action to the directors.

But more importantly, insolvency is a complex legal area and the nature of this advice is akin to legal advice and any person who gives such advice to small business should have to be licensed and subject to the same legal duties as registered liquidators or lawyers. The operation of unlicensed and unregulated pre-insolvency advisers is the single biggest concern facing Australia's insolvency regime and government action to properly regulate them is critically important.

2. Should there be a control mechanism to prevent the total costs of an external administration from consuming the value of the company's assets? What form could this take?

The Committees do not consider there should be a control mechanism to prevent the total costs of an external administration from consuming the value of the company's assets.

Where fee approval is being considered by creditors or a committee of inspection, they have the ability to refuse to approve the fees if they consider them to be too high. In such a case, the insolvency practitioner will need to seek court approval for the fees and the courts have the ability to consider whether the fees claimed are proportionate given the assets recovered in the external administration and often approve less fees than claimed on this basis. This is a sufficient existing control mechanism in our view.

Further, arbitrarily limiting a liquidator's fees to the value of a company's assets fails to recognise that there may be circumstances where a liquidator's fees may necessarily consume or exceed a particular company's assets, such as –

(a) where a company's assets have been deliberately depleted by directors prior to liquidation, especially in circumstances where such conduct requires investigation;
(b) where a company may be part of a larger group of companies placed in liquidation, and costs may well exceed the value of assets in one company in the group; or
(c) where a liquidator is obliged by law to carry out certain functions, notwithstanding that there are insufficient funds available in the company to pay for that mandatory work.

3. Should an information sheet of the average costs for a 'day in court' and the average numbers of court days for particular actions be included with each creditors report?

It is unclear to the Committees whether the information sheet is aimed at the costs which would be incurred by the insolvency practitioner in prosecuting actions or by a creditor in defending them (i.e. defending a preference claim). Irrespective of that, the Committees do not consider that an information sheet of the average costs for a 'day in court' and the average numbers of court days for particular actions should be included with each creditors report.

The legal costs involved in an action will vary significantly depending on factors such as the complexity of the claim, the court in which the claim will be brought, how vigorously the defendant opposes the claim, the lawyers involved and so on. Given the number of variables involved in determining the amount of legal fees involved in a court action, it would be very difficult to produce an information sheet with 'average' costs or 'average' number of court days for particular actions and if it was possible, it would have to generalise to such an extent that it would likely mislead those relying on it.

4. In consideration of technology available today, how beneficial would it be to automatically provide the *Annual Administration Return* report lodged with ASIC to creditors, directors, owners?

The Committees do not consider that the Annual Administration Return report lodged with ASIC should be automatically provided to creditors, directors, owners. However, the Committees consider that it would be beneficial if external administrators had an obligation to notify those creditors, directors and owners who had provided the external administrator with an email address to receive notices that the Annual Administration Return had been lodged and was available for them to download from ASIC's website.

The Committees note that the *Insolvency Law Reform Act 2016* (Cth) (**IRLA**) removed the obligation for liquidators to provide annual reporting to creditors because the Commonwealth Government had found that creditors were not interested in annual reports. Of course, there may still be a few creditors who are interested, as may be the directors and owners.

Given the Annual Administration Return may be lodged in a format which does not allow a copy of it to be sent to creditors, directors and owners, it would be better if they were notified that the Annual Administration Return had been lodged and that they can download a copy from ASIC's website.

5. Should valuations be provided to, and proposed marketing strategies require approval from, creditors?

The Committees do not consider that valuations should be provided to, and proposed marketing strategies require approval from, creditors.

It is important in any sale campaign that valuation information be kept confidential. If potential bidders had access to the external administrator's valuation, they could use the information to tailor their bids and it may lead to a serious risk that a reduced price is achieved.

6. Should demands to recover payments determined to give a creditor an unfair preference in a winding up require the registered liquidator to include the evidence they relied on in making that determination?

The Committees agree that a registered liquidator should be required, in demands to recover unfair preference payments in a winding up, to include a summary of the evidence relied upon in determining the amount repayable.

In our experience, liquidators often already provide an explanation in letters to creditors of the legal elements of an unfair preference claim and why they consider the elements are satisfied.

7. Should it be mandatory for individuals seeking to be directors of companies to undertake core education on running a business and the potential risks of personal exposure to liabilities before being eligible for appointment?

The Committees believe it should be mandatory for individuals seeking to be directors of companies to undertake some training on the duties, responsibility and risks of being a director of a company.

We endorse the Australian Restructuring, Insolvency and Turnaround Association's (**ARITA**) comments in this regard in its response to the Discussion Paper and support the idea of directors having to do a director course and pass a director test (similar to the test which a new driver must pass before being given a driver's licence) before being given a Director Identity Number.

8. Should it be mandatory for individuals seeking to start a company or register an ABN to undertake core education on running a business and the potential risks of personal exposure to liabilities?

For the same reasons as referred to at 7. above, the Committees believe it should be mandatory for individuals seeking to start a company or register an ABN to undertake some training on the duties, responsibilities and risks of being a director of a company or operating a business.

9. Where a small business seeks advice when facing financial difficulties, should the individual proposing a course of action be required to provide the small business with:

a. a hard copy plain language fact sheet that outlines the various types of external administration available and the role of directors and owners in each?

b. the reasons for recommending a particular course of action to the directors?

For the reasons referred to in 1. above, the Committees agree that any person that provides such advice should be required to provide the small business with:

(a) a hard copy plain language fact sheet that outlines the various types of external administration available and the role of directors and owners in each; and

(b) the reasons for recommending a particular course of action to the directors.

Again, for the reasons referred to in 1. above, the Committees believe that any person who gives such advice to small business should have to be licensed and subject to the same legal duties as registered liquidators or lawyers.

AFSA recently released a webpage which assists individuals consider which insolvency options are available to them given their specific circumstances - see https://www.afsa.gov.au/insolvency/cant-pay-my-debts/check-my-eligibility. A similar, appropriately tailored, resource should be made available to small business.

10. How can the safe harbour provision be improved to encourage small businesses to take action early and gain time to assess the viability of the business?

The Committees consider the following key issues generally prevent small business from accessing the safe harbour against insolvent trading:

(a) lack of knowledge of the safe harbour provisions;

(b) the tendency (as identified in the Discussion Paper) of small business owners to wait until it is too late to seek insolvency related advice;

(c) failure to have met employee entitlement payments and taxation lodgment obligations as required before safe harbour is available; and

(d) business owners/directors being liable under personal guarantees and having mortgaged their homes in support of their business borrowings which means that they don't really care about personal liability for debts incurred due to insolvent trading because they are already liable for many of those debts. This personal guarantee liability usually causes them to take more risks and trade for longer with the hope that they can turn things around and save the business because for them it is 'all or nothing'.

The requirement to have met employee entitlement payment and taxation lodgment obligations before safe harbour is available is clearly designed as a way of improving compliance with employee entitlement payment and taxation lodgment obligations. That is a policy decision, but it does mean that a percentage of directors (mostly of smaller companies) will not have safe harbour protection available to them.

The Committees support amending the safe harbour provisions to remove the employee entitlement payment and taxation lodgment obligation hurdles. The Committees consider there are already other provisions in place which adequately address the policy considerations mentioned above. Those are:

(a) the introduction of the single touch payroll system which now gives the Commonwealth much greater visibility on whether small businesses are meeting their superannuation obligations and the ability to take steps designed to have small businesses comply with their superannuation obligations;
(b) the personal liability of directors for unreported and unpaid superannuation and unreported and unpaid PAYG via the director penalty notice (**DPN**) regime; and
(c) the likely expansion of the DPN regime to GST via the proposed anti-phoenixing legislation.

However, even with the removal of the employee entitlement payment and taxation lodgment obligation hurdles, the other barriers to the use of the safe harbour regime by small business remain and so we expect the directors of small business will always be less likely to seek safe harbour protection than directors of larger companies.

11. How can accountants and bookkeepers best support small businesses to seek help early?

Accountants and bookkeepers should be encouraged to refer their small business clients who are under financial stress to insolvency experts (such as ARITA Professional or Turnaround Management Association (**TMA**) members) as soon as possible. Accountants and bookkeepers generally do not have sufficient insolvency law knowledge to properly advise their clients.

12. Should increased funding and resources be provided to the financial counselling sector to enable them to provide services to small businesses experiencing financial difficulty?

Yes, increased funding and resources should be provided to the financial counselling sector to enable them to provide services to small businesses experiencing financial difficulty. However, in the Committees' view, in order for them to provide appropriate advice about the options available to clients, financial counsellors need to have increased training on insolvency laws.

13. Should the impact on the mental health of small business owners and directors be cause for a pause in proceedings?

The Committees understand that directors/owners of small businesses can suffer significant stress when a company is placed into external administration and that can affect the mental health of the directors/owners.

External administrators should be trained where possible to recognise when a director/owner's mental health is suffering and how to direct them to obtain assistance from organisations who specialise in mental health.

However, the Committees do not consider that an external administration should be paused on account of its mental health impact on directors/owners. External administrations are conducted under timetables set by legislation, which are generally for the benefit of creditors and are designed to provide a return to creditors in the shortest reasonable timeframe. Once an

external administrator has been appointed, it should be primarily up to the creditors and the external administrator to determine the progress of the external administration.

In the Committees' experience, the appointment of an external administrator can also assist the mental health of directors/owners as it enables them to draw a line in the sand and hand over the pressure and stress associated with operating a business under financial stress to the external administrator.

14. Are there other changes that could assist the parties where there are mental health issues?

As noted in 13. above, external administrators should be trained where possible to recognise when a director/owner's mental health is suffering and how to direct them to organisations who specialise in mental health.

15. General submissions are sought on the fairness of having one system and the benefits and risks of implementing different processes so the costs and time to complete an external administration achieves the optimum outcome for creditors, employees and the company.

Financial Health Check

The Committees support the idea of a confidential concierge service for a fixed fee to access advice from an expert to review a small business's operations as suggested in the Discussion Paper. The panel of experts would need to be appropriately qualified and experienced and appointed by ASBFEO (ideally with input from ARITA and the TMA). The establishment of such a panel (with appropriate publicity, so that small business owners could easily see it was available upon an internet search) would also assist to reduce the number of small business directors/owners who engage unqualified and unlicensed pre-insolvency advisers to give them advice.

Pre-packs

The Committees support the introduction of a regulated regime for pre-pack sales in Australia. The Committees note recommendations 14.3 and 14.4 of the Productivity Commission's Report into business, set-up, transfer and closure in relation to pre-positioned sales, but the Committees:

(a) do not support any pre-pack regime which requires the appointment of a different external administrator than that who advised the company on the sale process. That is because the Committees:

    (i) do not consider the criticism of the UK's pre-pack regime (i.e. lack of independent review and lack of transparency) outweigh the benefits able to be achieved from pre-pack sales; and

    (ii) consider that if a different external administrator is required, the regime will, in essence, be no different to the current regime where a liquidator appointed after pre-appointment business transfer has a duty to investigate the terms of the sale and determine whether to challenge them;

(b) support a regime which requires the insolvency practitioner who advises on the pre-pack sale to have to comply with certain obligations to ensure that the business assets are

sold for the best possible price in the circumstances (which can be set out in a statement similar to the UK 'SIP 16') and published by ASIC; and

(c) consider that if creditors are concerned about the lack of an independent review of the sale, they have sufficient rights already and can avail themselves of their ability:

(i) in an administration, to replace the administrator at the first meeting of creditors;
(ii) in a liquidation, to call a meeting of creditors and resolve to replace the liquidator; or
(iii) apply to the court for the appointment of a special purpose liquidator to review the sale.

Other comments

The Committees support a streamlined small business liquidation process in the form in recommendation 15.1 of the Productivity Commission's Report into business, set-up, transfer and closure.

The Committees also support the introduction of a micro structuring process along the lines advocated by ARITA in its 'A Platform for Recovery 2014' policy paper and which ARITA refers to in their response to question 15 of the Discussion Paper. However, the Committees do not consider that related parties should not be able to vote for or against the proposal. Related party creditors are treated equally with other creditors when it comes to voting in all other insolvency processes in Australia and there is no reason to change that in a proposed micro restructuring. If there is a concern about related party creditors being able to control the voting, that can be dealt with by including a right for disaffected creditors to apply to the court to set aside the arrangement if the vote of related party creditors affected the result of the vote. Such rights currently exist (see section 75-41 of the *Insolvency Practice Schedule (Corporations)*).

Please contact the Chair of the Insolvency & Reconstruction Law Committee (Scott Butler, sbutler@mccullough.com.au or 07 3233 8653) if you require further information or clarification.

Yours faithfully

Greg Rodgers
Chair, Business Law Section