Ms Kate Carnell
Australian Small Business and Family Enterprise Ombudsman
GPO Box 1791
Canberra ACT 2601

PO Box 283
Isle Of Capri
QLD 4217

29/1/2020

Comments and suggestions submitted Aylward Street

Dear Ms Carnell,

Comments and suggestions submitted by Aylward Street

Please find below our submission re the *Insolvency Practices Inquiry*.

Questions (as per Pages 3 and 4 of the Discussion Paper):

1. Agree with 1 (a) suggestion. Even well-educated people do not know the difference between a liquidator, a receiver, a voluntary administrator and other forms of external appointments let alone the technical differences regarding appointee objectives, influences and Director's powers. For such a momentous appointment affecting their life's work in many cases, there is no reason not to have an officer of the court hand the prospective " client" a fact sheet and we see no reason to charge for this. It would be helpful if such a fact sheet did not have any PI insurance ramifications and was not taken as advice. Perhaps ASIC could publish it.

   A liquidator should definitely not recommend a course of action as, without prior knowledge and direct experience, they have not conducted any form of pre-appointment business viability assessment, any meaningful diagnosis as to the causes of the problems (e.g.. is it a bad business or is it bad management) and therefore it would be highly improper for them to make a formal recommendation as it would or could constitute a " ready fire aim" solution.

   The hardest aspect for a Voluntary Administrator confronted with an appointment which is in respect of a sound business with a balance sheet in desperate need of restructuring is that it may be the case that the safe harbour legislation could be applicable i.e. an informal turnaround/ restructuring however if this course is adopted, the appointee loses the statutory protection for his fees which plausibly could tend to guide the candidate more to a potentially damaging VA instead of a more informal workout. Fees paid in priority to working capital needs which are already in a precarious condition would prolong any DOCA (zero% - 9% payout).

   This temptation, which is not submitted as likely occurrence , could be resolved by removing the privileged fee priority position. The appointee will then work harder to turn around the company. The appointee will look harder to see if the business can in fact be turned around before taking on the job. It generally doesn't take long to assess an SME and some programs can obtain a detailed headline assessment inside three hours where say 8 key questions are answered and then fed into a short analytical program resulting in an headline preliminary viability assessment.

2. Yes - in respect of the appointment of a receiver manager and voluntary administrator.

   a. Cut the costs : Streamline the ASIC reporting requirements as liquidators whinge about “all the form filling which costs a fortune".

   b. Have the proposed liquidator prepare a detailed fee estimate / fee estimates indicating the costs range of the external appointment ab initio and have the legislation limit the fees to the mid point of the quote.

   There should be "strike hard rock" clauses to cover unpredictable events such as unforeseeable negotiations, court actions and incremental fees should should be approved by an ASIC specialist panel. There are around 220 insolvencies per week and of these perhaps 60 or so may need to use the fee protection clause.

3. Yes - but to be estimated as per 2b above. There must be a "no fee surprises" control mechanism.

4. It would be beneficial as the information would act as a guide to Directors and creditors of the brutal reality of insolvencies and potentially increase vigilance and awareness of insolvency threats and causes.

5. Businesses should fight to trade on if, based on an independent and objective diagnosis, shareholder value is likely to increase as a result of a rationalisation and restructuring. All creditors' positions would be emphatically strengthened if such a plan was successfully enacted. Insolvency practitioners alone are not the optimum experts to opine on how probable it is that management can thread together the vital management functions : marketing, operations and management control.

   If the business is not viable, a specialist ought to opine stating the reasons. If the business is viable but the management is deemed bad (thus ruining the chances of a better return to creditors) as a result of a thorough objective analysis then it would be beneficial for an independent expert report to opine accordingly providing detailed reasons. This matter ought to be voted on by creditors as they are relying on management to implement the recovery.

   The legislation could be amended to grant a period of up to 90 days to appoint an interim "Chief Restructuring Office " on say $275 per hour limited to 10 hours a week. The moratorium would also allow time to find either a new MD or to seek to sell the business as a going concern with such action likely to prove to be more in creditors interests.

   The optimum position would be to table shareholder valuation opinions assessed on various scenario bases (e.g. assets sale, going concern business sale, quick sale, liquidation etc) **predicated on a viable recovery plan as foreshadowed under the Safe Harbour legislation.**

   Every business MO has an "owners' footprint " which will incorporate a sales, merchandising and marketing strategy. All Secured Creditors as well as unsecured creditors occupying say the top 25%-35% of unsecured debt will have an interest in the turnaround plan particularly if the contemplated dividends are planned over a long period.

   On balance we think that it is neither wise nor necessary to provide a detailed sales and marketing plan but tabling a headline (no -recourse) plan for creditor approval would be valuable as the sponsors would work more diligently to table a better plan; creditors interested in voting will be in a position to form their own view of how the planned changes might affect their future debt recovery dividend prospects. This approval, supported by the headline plan, reduces the present "hope" or blind faith factor and adds a degree of objectivity not otherwise presented to the creditors. Additionally, measurable milestones governing the scheme are in a position to be assessed regularly.

   Naturally, disclosures would need to bear in mind commercial - in - confidence factors (e.g planned price changes) and the potential impact as no doubt all competitors would eagerly read such a report in order to seek tactical advantage.

6. The idea is to make the demand at the lowest administration cost. Liquidators routinely table demands and if the liquidators are unfunded, they are normally unable to sue the creditor concerned on commercial grounds. Many creditors sense this and ignore the liquidator's 2-4 demand letters. If the creditor has read the Director's statement they may see that the liquidator will have trouble funding an action no matter how strong the evidence is.

   However, given the propensity of many debtors to not pay a liquidator it makes a lot of sense, without trapping the Liquidator legally, for the liquidator to ram home the clear breaches of the Corps Act supported by the evidence he has gathered to support his/her claim. This may cause the recalcitrant debtor to enter into negotiations for settlement if they sense that the matter is more serious than they otherwise believed. So yes, it is a good idea as it could raise more funds for the administration and the creditors' pool.

7. Yes. An MD or CEO running a business is fundamentally in charge of obtaining a return on (a) Plant (b) Receivables and (c) Inventory. The individual seeks credit from the industry suppliers making the seeking of credit a very serious business.

   In our experience, many MD/ CEO operators have more experience in marketing and operational aspects and often zero or elementary knowledge in the management control aspects (governance aspects including planning, financial control, risk management and related matters).

   Through a related company, we have conducted major experiments over nearly four years and run programs which teach uneducated attendees the fundamental 12 pillars of business. These have received wide acclaim from important government departments and QUANGOS in Qld and NSW as well as attendees.

   We have also trialled explicit two day in house management control seminars for managers wishing to manage trading investments. They are unable to do so unless they receive a 100% examination score.

   The evidence to us is that managers / owners wishing to become Directors MUST (we believe by statute) and for their own sakes and those of their creditors complete a easy to understand online program which provides them with the vital knowledge about risk, return, the relevant laws and key aspects of business and financial management with an emphasis on the key elements which impact on the generation of free cash flow.

   So yes, we believe from over 40 years of in the trenches experience that core education ought to be undertaken. It must become compulsory in order to have any material effect.The advantages would include fewer people jumping in blind and losing their shirts alongside a reduction in the number of insolvencies and human carnage/damage.

8. Same response as per Point 7.

9. (a) YES. The fact sheet ought definitely to be published by ASIC on a no liability basis replete with hard-core case studies akin to the ATO case study method available on their web site.

   (b) Of the (circa) 35,000 practicing accountants in Australia, less than 5% are qualified to give the detailed professional advice a client requires as they are too busy focusing on compliance and accounting work and other services not related to insolvency management.

   Most are also not sufficiently experienced in this delicate and dangerous field. They are not equipped structurally to deal with services such as crisis intervention and stabilisation and detailed diagnosis and evaluation as, done properly, these are on-site / field services. Consequently, we are aware, that in nearly all cases when confronted by a client in distress, most non top 8 accounting firms appear to quickly refer the distressed client to insolvency practitioners to gain the advice about what to do.

   Thus the distressed client first of all is somewhat (unintentionally) terrorised by the insolvency practitioner spelling out the risks under S 588G et al and also the benefits of doing a VA. The big pitch is that not only will the client limit insolvent trading risks but that the highly destructive and stressful pressure the prospective client is under (savage creditor pressure and psychological aspects) will be largely alleviated by signing the appointment of a VA.

   We are aware that in circumstances where a DOCA is discussed or relevant that clients are told " you don't have to pay us (the Voluntary Administrator) a cent as the funds will be paid from the company cash flows and they will improve immediately as all creditors are frozen upon our appointment.

Our issues are two fold:-

1. The working capital position of the company is most likely already, pre-appointment , under severe and often unmanageable stress. The impact of the creditor freeze (which can totally destroy valuable relationships and any goodwill) does indeed improve the cash flows but the first bite of the financial cherry is in favour of the administrator with the resultant financial impact that the working capital of the company is severely depleted even further by the practitioner's fees which seem to vary between $52,000 and $92,000 for smaller business. This comment assumes that a Receiver manager has not been appointed.

2. We are somewhat troubled by the fact that the administrator may or may not tell the client pre- appointment that his/her fees can easily blow out and that his/her fees rank as statutory priorities. The real point is that any human confronted with the choice of statutory fee protection or working hard at risk to do an informal workout may not explain this position. Particularly in the light of the (untested) safe harbour legislation. Realistically : anyone would prefer an effective (semi) Government backed protected fee base as opposed to an at-risk fee structure with the risk largely driven by how talented and experienced you are in helping to turn the company around. There is a balance which must be found here; one which drives VA performance and results rather than building a debtors ledger for the VA.

10. **Safe Harbour**

The wider issue in our experience is that business owners fail to take steps early enough to avoid the crisis including breaches of covenants. There is really no legally enforceable incentive (common sense not being so common) for Directors to take preventative measures which, if enacted, could avoid the financial catastrophe in the first place.

It can take anywhere from say two months to ten years to reach an unmanageable crisis position. Management is largely to blame here as, for a variety of reasons noted in our experience, including arrogance, pride, denial, ignorance, conceit and lack of leadership (to name a few management problem areas) they simply fail to properly diagnose and evaluate the nature of the problems and therefore fail to take corrective action soon enough. We all know this but what can we do?

Around 20 years ago the Government introduced the ephemeral National Training Levy. At the time we thought it appalling that a Government needed to legislate to ensure that a business needed to train its workers . Our thoughts were published in the AFR. Notwithstanding this opinion, in respect of the subject matter and in particular the desperate need to avoid financial loss to creditors and shareholders, it makes a lot of sense to do this:

a. As with any professional body, legislate for all Directors to spend 25-40 hours a year (PD) on critical and practical aspects of the Corps Act in order to (a) allow a Board appointment ab initio and (b) retain their position on the Board unless they undergo explicitly targeted PD hours.

b. In the statutory curriculum, have say 25% of the topics relate to specialty topics which aren't specifically related to the Statutes. E.g How to groom your company for a maximum selling price.

c. Have the attendance compliance enforced by ASIC who may collaborate with other institutions such as the AICD or AIM or others to present the programs.

As far as safe harbour legislation is concerned we believe that it is a great start. Workouts and informal arrangements ought to burgeon and the devastation often associated with an external appointment will be curtailed to some extent where legally feasible. The need for the Safe Harbour " better result for creditors " is important for both creditors and shareholders alike.

Whilst we support the idea that a Director can formulate his/her own plan we do think that it ought to be mandated that sign off on the plan be provided by:

a. An unrelated commercial accountant (CPA/ CA) with not less than 15 years commercial experience; or

b. An unrelated businessperson with not less than say 20 years business experience including 10 years as a Managing Director; or

c. A nominee of the AICD or any recognised accounting body who qualifies with (a) and (b) above; or

d. An insolvency practitioner and related parties who will not accept and is permanently recused from any formal appointment with the subject.

There should be a form signed off by the qualified party which says (inter alia):

1. We have carefully examined the strategy and believe it to be sound provided that it will be properly executed.

2. We have reason to believe that compliance with taxation and staff requirements under s588G can be met.

3. We have examined the marketing plan of the business and believe it to be sound.

4. We have reviewed the operations plan of the business and believe that it is sound.

5. We have reviewed the management control and governance plans of the business and believe them to be sound and size appropriate.

6. We believe that if the management can achieve the budgets that the better option for the creditors is to support the plans tabled as these plans, if enacted, are likely to produce a better option for creditors and shareholders.

11. **Support from accountants et al.**

a. At the business establishment phase they must ram home the importance of **detailed business viability assessments**, the need for regular profit measurement, balance sheet and free cash flow monitoring and other size appropriate governance controls such as budgetary controls and updating business plans. i.e. spell out the need for **size appropriate corporate governance.**

b. Get the accountants to send their SME clients regular monthly news-letters with the latest on SME corporate governance encouraging SME's to lift their monitoring efforts; regularly remind Directors of their ongoing onerous obligations.

c. **Accountants need to re-train themselves rather urgently** in our opinion, in around 22 different business related subjects all of which, if sold as services would be of immense value to their clients and their own practices.

12. As inferred above under Item 10 there is a compelling need for education such that instead of having less than 5% of advisors having any expertise in the distressed company sector, aim, via education and other means of emphasis, to educate not just prospective owners and Directors but also existing Directors and we think accountants.

    For the long term seek to re-shape the shroud and externally viewed perspective of shame and humiliation of insolvency such that it is not seen by the community as a humiliating defeat and chronic lifelong failure but alternatively one of having experienced "war wounds, battle scars and combat shrapnel".

    We do feel that appropriately structured financial education and related advisory services in this very specialised area would benefit small business as not only would the *preventative aspects be highlighted* but also the **pivotal aspects of managerial responsibility** could be shunted home in a more pragmatic and effective manner for the benefit of all SMEs.

13. All too often we have seen parties in financial distress react in very different ways such as:

    - Owners literally hiding in the corner of the warehouse from sheer fear, humiliation and exhaustion.
    - Terrible marital and widespread family breakdown.
    - Owners engaging in highly irrational conduct contrary to their best interests.
    - Major breakouts of health problems such as massive body rashes.
    - Owner hospitalisation through fear of creditors.
    - General psychological breakdown and decision making capabilities suspended.

    Often these people are former energetic, driven and focussed people who are completely unable to think rationally for a period or who maybe, through fear and uncertainty, temporarily unable to cope.

    We believe that, in the absence of fraud and other forms of chicanery, that the driver of the business ought to be given a tight conditional moratorium not exceeding one month (any more is likely to be impractical for SME's) to seek external assistance so as to be in a superior position to craft a sensible plan for the benefit of creditors. After all, one doesn't "throw away a gun because it misfires once".

    The other point is that we have found in many instances where an external controller is appointed, the person who has laboriously built up valuable relationships with customers and staff, not to mention strategic suppliers, is blamed for all mishaps and summarily dismissed on external appointment. This is usually done on a *"ready fire aim"* approach (after all the court appointed officer now has 100% of the power) which can spell disaster for the creditors; these decisions can stem from a lack of balanced business experience, lack of obtaining a comprehensive understanding of what and who has caused the underlying problems and exactly what strategic alternatives exist for the subject.

    Taking time to properly understand these matters will allow for the optimum solution as the evaluation will give the let the controller determine whether he/she is dealing with a bad business/ bad management or one which can in fact be saved BEFORE spending up to $100k on a privileged appointment. In other words, taking a balanced investigative approach rather than get rid of the MD before an intelligent evaluation is conducted.

14. An interim quasi panel or trusted party could be appointed during the interregnum period on a no recourse basis.

15. One has to be careful not to interfere with the capitalistic system in any way. We do have other comments to make but have run out of time having only discovered the questions in the last few days.

Please call or email if you want our further opinion.

Damian Street