27 January 2022

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Parliament House
Canberra ACT

By email corporations.joint@aph.gov.au

Answers to questions on notice from Senator Scarr, made during the public hearing on 13 December 2022

We provide the following comments and further recommendations to our written submission dated 30 November 2022, as a response to the questions on notice provided by Senator Scarr during our appearance before the Committee at the public hearing on 13 December 2022. The relevant exchange from Hansard is:

> Senator SCARR: Do you think that they could be substantially amended, or are there tweaks that could be made that would make them fit for purpose?
>
> Dr Harris: Yes, I wrote a PhD thesis on that.
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> Senator SCARR: Did you? You should join Treasury!
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> Dr Harris: There are about a dozen changes to the SBR regime that I think would make it work better and make it fit for purpose.
>
> Senator SCARR: - have read your paper, but can you draw out some particular proposals for reform with respect to both processes and even whether you've had an opportunity to perhaps respond to some of the issues raised in this respect by ARITA, the Law Council and also the Australian small business ombudsman?
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> Dr Harris: Am I taking that question on notice and providing a supplementary answer?
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> Senator SCARR: Yes. If you could give us a formal response to some of their suggestions, that would be useful.

We offer the following comments on the ARITA, ASBFEO and Law Council submissions in relation to Part 5.3B and simplified liquidations.

Comments on ARITA's submission on Part 5.3B and simplified liquidation

We support ARITA's recommendations 1-5, which overlap which are consistent with our own written submission and public evidence before the committee on 13 December 2022.

We agree with ARITA's recommendation 7 and 8, which both suggest that further simplification is needed for Part 5.3B and simplified liquidation. We agree with ARITA's comments that the

Part 5.3B and simplified liquidation procedures are not fit for purpose, because they are too complicated and not flexible enough to suit the needs of small businesses in financial distress.

Comments on ASBFEO submission on Part 5.3B and simplified liquidation

We support Recommendation 2 - making information easier to access to understand for small businesspeople.

We strongly support Recommendation 3 - to undertake a broad insolvency reform process. We provide reasons for this in our principal written submission. We agree with the Ombud's list of key areas for reform (simplification, streamlining, preserving enterprise value, transitioning to a digital model and broadening restructuring practitioners beyond registered liquidators).

We note that Recommendation 4 of the Ombud's submission suggests a review of Part 5.3B, which has now been undertaken by ASIC in Report 756 of 17 January 2023.

We note that Recommendation 5 suggests consideration be given to features of foreign insolvency laws (such as Canada and the United States). We suggest that this would be an appropriate term of reference for a broad insolvency review. Professor Harris teaches comparative insolvency law in Canada and has extensive knowledge of both the Canadian and US bankruptcy systems and would be happy to discuss these further or answer any further questions on notice.

We support Recommendation 6 to consider a single insolvency statute, but suggest that this would be an appropriate term of reference for a broad insolvency law reform review project as discussed in their Recommendation 3.

We support the comments made in relation to Recommendation 9, which we discussed in our oral evidence before the inquiry committee on 13 December.

Comments on the Law Council of Australia's and simplified liquidation submission

It should be noted that Professor Harris is a member of the Law Council's Corporations and Insolvency Committee and took part in the discussions on formulating the Law Council's submission.

We note that the Law Council suggests that Part 5.3B is not much cheaper than voluntary administration in Part 5.3A, a statement that we agree with. We also agree that further simplification of the procedure would be beneficial (as we discuss below).

We agree with the Law Council's suggestion that greater flexibility should be introduced into the eligibility criteria.

We agree with the Law Council's suggestion that further flexibility in the simplified liquidation procedure could be beneficial.

Our recommendations to improve the operation of Part 5.3B

In our view, Part 5.3B does not provide an attractive and effective small business restructuring regime. The relatively low numbers of appointments (less than 200 in two years) and the low rates of return (approximately 15c in the dollar, as reported by ASIC in Report 756 (17.1.23)) suggest that the procedure is not attractive to the majority of small businesses in financial distress. Furthermore, the fact that very few registered liquidators have done more than one Part 5.3B appointment also suggests that the procedure is not attractive for insolvency practitioners or their debtor clients. We note that within the first two years of voluntary administration (Part 5.3A) which commenced in 1993 there were more than 2,200 appointments. In summary, Part 5.3B is too restrictive and lacks appropriate incentives for directors, creditors and restructuring practitioners to be of broad utility. We also note that ASIC's Report 756 demonstrates that the ATO is the majority creditor in value in 79% of cases that proceeded to a plan, including in 50% of cases where the ATO controlled 90-100% of the admissible claims.

We offer the following recommendations for reform:

1. If the ATO is the primary creditor (and in many cases the only creditor) with an admissible claim, then the use of a Part 5.3B restructuring is not appropriate and a waste of money and resources. There should be a more direct mechanism to compromise debts owed to the ATO rather than needing to appoint an insolvency practitioner to conduct a vote where the only creditor is the ATO. We recommend a review into the possibility of amending the tax laws to allow the Commissioner of Taxation to compromise tax debts as part of a good faith commercial arrangement (a "workout") rather than needing to engage a formal insolvency process to achieve the same result.
2. Extend the stay against the enforcement of related party guarantees for the duration of the restructuring plan. This would provide an incentive for debtor management to use the procedure as they (or their relatives) are often providers of guarantees to cover the company's debts. Without protection against guarantees during the restructuring plan, the directors and/or their relatives are vulnerable to enforcement even if the company is successfully restructured. This discourages directors from seeking assistance from a restructuring practitioner. Even beyond the period of the plan, we note that consideration has been given to having all directors' personal debts of a corporate small business, incurred through guarantees or otherwise, being capable of resolution or at least co-ordination through the one insolvency process. This will be addressed further in our response to the questions on notice to which answers are due by 10 February 2023.
3. Provide the debtor company with greater flexibility as to what a restructuring plan can include. The current law limits the capacity to include common restructuring tools within a plan, in favour of mandating certain terms and limiting the plan to compromise and/or debt rescheduling. While promoting simplicity and reducing transaction costs by including standard terms is beneficial, these should be like Corporations Regulations 2001 (Cth) Sch 8 and 8A, which provide default provisions for schemes and deeds of company arrangement, not mandatory provisions that can't be changed.

4. Allow restructuring practitioners to make remuneration determinations as per the standard rules for such determinations. ASIC’s Report 756 notes that the median remuneration for restructuring and restructuring plans was relatively low (approximately $22,000), which is lower than for a voluntary administration and a deed of company arrangement (as discussed in the empirical work in Prof Harris’ PhD thesis). However, requiring remuneration to be agreed in advance of the appointment and remuneration for a plan to be limited to a percentage of distributions (again agreed to in advance) introduces risk for the restructuring practitioner if the directors fail to give full disclosure and the company’s circumstances are in fact more complex than initially suggested. This may discourage insolvency practitioners from taking the appointments. The restructuring practitioners are highly regulated professionals and fiduciaries and should be able to negotiate the basis for their remuneration with the debtor management and then have this open to challenge (or perhaps requiring confirmation) by creditors when the restructuring plan vote is conducted.
5. Give the debtor company greater flexibility to manage the business by revising and simplifying the list of exceptions to the stay during the restructuring period and to allow the debtor company to manage the business in the ordinary course by removing the prohibition on selling some of the company's property without the restructuring practitioner's consent. The current scope of Part 5.3B is not a full debtor-in-possession regime because it requires the restructuring practitioner to give consent to a broad range of transactions. While the restructuring practitioner can and does play an important accountability and transparency role in monitoring the progress of the restructuring process, there should be greater flexibility for the debtor to carry on business in the ordinary course. The specific exclusion in the regulations for asset sales from the ordinary course of business should be removed. Asset sales (though not selling the entire business) are common restructuring and turnaround techniques and should not require approval from the restructuring practitioner or the court.
6. Improve transparency and engagement for creditors by providing more information about the company's financial affairs and a recommendation from the restructuring practitioner as to how creditors should vote. The notices that are required to be sent to creditors together with the restructuring plan are too brief and don’t require full disclosure by the debtor company’s management of the company’s financial position. A list of debts and details on the restructuring plan is not enough. A statement of affairs in the form of a ROCAP should be provided. This is one area where Australian law is out of step with other small business restructuring procedures such as the CVA in the UK, Proposals under the Bankruptcy and Insolvency Act in Canada, simplified restructuring in Singapore and Subchapter V restructurings under the US Bankruptcy Code.
7. Allow for a creditors' meeting if a sufficiently large proportion of the creditors require it. Removing the default creditor meeting will save costs, but if the majority of creditors (or if a major creditor) wants a meeting to discuss the plan, this should be available.

8. Impose a headcount test for creditor approval in addition to the current value test. At present only the majority in value of creditors responding to the restructuring practitioner's vote request can approve a restructuring. This opens up the potential for interests friendly to the debtor management pushing through a restructuring proposal. We note that ASIC's Report 756 notes that related party debt is a relatively small percentage in restructuring plan cases (less than 10%) and that in 79% of plan cases the ATO has the majority in value of admissible claims. However, a headcount test is common in both insolvency and restructuring cases where a majority in number and value is needed. This could be done even by requiring a majority in the number of creditors who respond making up the majority in value, which would be consistent with the deemed consent model used in the UK for voting by correspondence as well as the model adopted by the authors of the World Bank's report into SME insolvency in 2017.
9. Determine creditor debts and claims at the start of the restructuring period rather than at the time for voting. The current procedure for determining creditor claims is designed to be quicker and cheaper than standard proof of debt adjudications by insolvency practitioners. However, the current Part 5.3B procedure has the potential to increase delays, costs and complexity in disputed matters because the timeframe for conducting the vote (15 business days) continues even if a creditor disputes the debts and claim schedule, which may then require the restructuring practitioner to revise estimated plan distributions to creditors even after they have voted by correspondence. This is another reason for having the option of conducting a creditors' meeting to provide a forum to resolve such disputes and conduct a formal vote.
10. Broaden the eligibility criteria beyond liabilities of $1 million. We note that in the United States an initial threshold of $2.7 million was introduced, but that this was soon increased to $7.5 million until 2024. The US small business restructuring (Subchapter V of Title 11 USC) has been used over 4100 times since 2020 (according to statistics provided by the American Bankruptcy Institute on their website). We also strongly suggest that the restrictions on using Part 5.3B where employee entitlements are not paid in full should be amended to allow for those unpaid entitlements to be made whole under the terms of a restructuring plan. The current eligibility criteria mean that most small businesses cannot use the procedure.
11. We note from the January 2023 ASIC report that only one small business restructuring practitioner has been registered as such since 1 January 2021, with six applications for registration having been rejected. The reasons for rejection are not known but this seems an odd outcome given that the revised and lesser criteria for registration were meant to broaden and diversify the pool of those conducting Part 5.3B administrations. We suggest that consideration be given to either further broadening the criteria or extending the composition of those on the selection committees.

Recommendations to improve the operation of simplified liquidation

1. The timeframes for deciding whether to adopt the simplified liquidation process are too short. Section 500 requires the liquidator to decide whether to adopt the process within the first 20 business days of the triggering event, but the liquidator is also required to notify the creditors at least 10 business days before deciding whether to adopt the process, which effectively requires the liquidator to decide within the first week as to whether they will adopt the procedure. This is not enough time to evaluate issues relating to potential voidable transactions that may be available under a full liquidation and not available under a simplified liquidation. We suggest a longer period is needed for both timeframes.
2. The simplified liquidation procedure appears to lack any incentive for its use. It is, unfortunately, not that much simpler than a standard liquidation. Consideration should be given to further reducing reporting obligations and streamlining communication processes (such as by ASIC creating industry standard pro-forma documents that could be used). We note that ARITA's submission states that, in the experience of its members, simplified liquidations are actually less efficient and more costly than a full liquidation.
3. The eligibility criteria are focused on preventing phoenix activity rather than facilitating streamlined liquidation processes. Phoenix activity can be addressed by more and more effective ASIC enforcement. It is not necessary to limit simplified liquidation to companies that don't include a director who has previously been a director of another company that used restructuring or simplified liquidation for 7 years. If the goal is to reduce red tape and streamline the process, restricting the eligibility criteria is counter-productive. We should be encouraging more companies to use the quicker and cheaper regime. Addressing phoenix activity should be left to voidable transactions, directors' duties and Pt 5.8A. More effective enforcement of these provisions by ASIC (or funded by the Assetless Administration Fund) would provide better outcomes than locking out companies from the Part 5.3B procedure simply because someone connected with the company had a similar situation up to 7 years before.

Update of 30 November 2022 submission

At footnote 16 of our submission, we refer to a then "forthcoming" article – *Rethinking Insolvency Practitioner Remuneration*, (2022) Insolvency Law Bulletin. That article has been published under that title with a reference of (2022) 22(3&4) INSLB 33 M Murray. A copy is enclosed.

Contact

Please contact us if we can explain or assist further or if there were other matters you consider we were on notice to respond to. We note we are to respond to a list of questions on notice by 10 February 2023.

J Harris
Professor Jason Harris

M Murray
Michael Murray