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Manager
Market Conduct Division
Treasury
Langton Crescent
Parkes ACT 2600

By email: *MCDInsolvency@Treasury.gov.au*
cc: Matthew Bowd & Christine Barron

Dear Christine and Matthew

INSOLVENCY REFORMS TO SUPPORT SMALL BUSINESS

The Australian Finance Industry Association (AFIA) welcomes the opportunity to provide feedback on the Exposure Draft Bill in relation to the Insolvency Reforms to Support Small Business (Draft Bill).

AFIA represents over 100 providers of consumer, commercial and wholesale finance in Australia including retail banks, finance companies and fintechs, which provide innovative consumer products and specialised finance to meet small to medium enterprises (SMEs) working capital, cashflow and investment needs. For more information about AFIA, please see **Attachment A**.

AFIA's role as an industry body is to drive industry leadership and represent members' views, facilitate self-regulation through industry codes, and to work with the Federal Government, financial regulators, and other stakeholders to promote a supportive environment for the financial services industry.

OUR SUBMISSION

At a macro level, consistent with our Pre-Budget and other submissions, AFIA supports continued efforts by the Commonwealth Government to respond to the effects of the COVID-19 pandemic on the economy and in particular on Australian small businesses. In particular, we support the development of a streamlined framework to support small to medium businesses to restructure, or alternatively, if this is not possible, to wind-up business through a cost effective, efficient and streamlined manner.

We understand that further clarity on the content of Regulations is going to be forthcoming.

We have some comments where further detail is required to ensure the proposed new framework is robust and achieves the right policy settings for economic recovery without compromising continued access to credit for small businesses.

As part of any future solution, these Regulations need to ensure the current security hierarchy (i.e. rights and remedies available to secured, partially secured and unsecured creditors) is not materially disrupted so as to not:

- Negatively impact future access to credit for small businesses via domestic and international funding markets, who rely on this hierarchy to right price small business facilities; and
- Lead to inadvertent consequences for creditors, many of whom are themselves small businesses.

As part of the next consultation process, it will be important that more detail is provided to address the above points. The enclosed attachments provide more detail but in summary, our key recommendations in relation to these reforms are below.

KEY RECOMMENDATIONS

1. *Regulations need to bring clarity to key areas:*

As outlined in Attachment B, regulations need to bring clarity to the following.

<u>New debt restructuring process</u>

As an overarching comment, for the new process to be effective, creditors must have the opportunity to be in open dialogue with the Restructuring Practitioner during the formulation of the restructuring plan, including allowing creditors to challenge or raise concerns with the process or the plan itself. We note also that further detail is required on the below key aspects:

- What is the definition of small business in scope for these reforms – we recommend liabilities (as defined as excluding secured, partially secured or related party debts) do not exceed $0.5m not the proposed $1m as, currently, 78% of businesses in insolvency have liabilities of under $1m.
- Who is responsible for meeting debts incurred during the restructuring process – noting, at present, an insolvency practitioner is accountable for all debts incurred post appointment after relevant decision periods.
- Do debts incurred as part of the restructuring process need to be paid in priority to debts at appointment – i.e. is this equivalent to an 'informal' standstill amongst secured and unsecured creditors. As part of this, how will the interests of lenders who provide balance sheet and revolving finance (with charges over assets such as stock, debtors, creditors) be dealt with and preserved.
- Who is captured by the 50% approval regime – is this just unsecured creditors or the unsecured excess over debt of secured or partially secured creditors and if the later, how is this calculated – noting that secured creditors cannot realise assets during the restructuring period.
- How will the Restructuring Practitioner consent to asset sales, including any obligation to value assets similar to s420A of the Act. Strong controls and oversight from well qualified

Practitioners need to be in place when allowing assets to be sold or asset sale transactions to be entered into during the restructuring period. If this does not occur, credibility in the Scheme will be compromised and future willingness of lenders to approve other Restructuring Plans will be undermined.

- What is the process to allow the Restructuring Practitioner to consent to a secured party exercising its security interest during the restructuring period.
- How are contingent liabilities under personal guarantees captured or calculated and how are creditors who purchase debt dealt with.
- How will the registration of security in transition interests (i.e. those yet to the be formally registered) be dealt with.
- What are the rights and remedies available to secured and partially secured creditors during this process – it seems the voluntary administration provisions will prevail but these do not impose requirements to formally approve proposed terms of a Deed of Company Arrangement and secured creditors are bound only to the extent their debt exceeds the value of their security interest.
- How does this process include learnings from the evolution of Debt Agreements to ensure that there are protections in place to reduce the risk that companies (and their directors) commit to restructuring plans that are credible and do not go for too long (we recommend a maximum of 2 years be adopted) or to payment levels beyond which are feasible.
- What is the position of outstanding taxation liabilities – as we currently understand the process, taxation lodgements need to be up to date but this does not mean that all outstanding taxation commitments need to be paid prior to entering into a new debt restructuring process. (Please note that this proposed approach may prevent companies, whose debts comprise predominantly of taxation debts, from accessing this process which could be to the benefit of creditors as a wider body).
- How do superannuation entitlements fit into the process. We propose that they are captured in a similar manner to outstanding tax liabilities i.e. lodgements not payments need to be up to date.
- What does 'meet all outstanding employee entitlements' mean – we propose that flexibility be provided such that an approved plan can include sufficient cleared or reasonably cleared funds to meet these entitlements.
- What is proposed in relation to the current security hierarchy (i.e. rights and remedies available to:
    - PPSR registered security
    - Secured creditors over fixed and balance sheet assets
    - Pursue a guarantee of a liability of the company outside of the initial 35-day restructuring period)

  We recommend that this is not materially disrupted from current insolvency law as this could impact on future access to credit and international funding markets who rely on this hierarchy to manage credit risk and right price small business facilities. Creditors (whether secured or not) must be able to continue to enforce rights and remedies against guarantors and directors who are joint and severally liable after the restructuring period has ended, consistent with the current Voluntary Administration process.
- What are the certification and recourse requirements on the Restructuring Practitioner to approve the Restructuring Plan – balance needs to ensure there is sufficient rigidity in the

process but not too much such that existing alternatives i.e. a full insolvency requirements do not become the fall back or 'safer' position.

- How will the rights of creditors not contacted or identified in the process be managed. To prevent potential misuse of the system, by not disclosing some of the company's creditors, other notifications methods including requiring notification to be made on the company's website etc. should be considered.
- What is the process to minimise potential phoenix activity by recent directors – there should be anti-avoidance provisions to prevent owners from running down company assets or transferring them to another company, in order to qualify for the restructuring process.
- We understand that a number of small businesses are conducted through trusts. How will the restructuring and streamlined liquidation processes deal with trusts – noting that the appointment of either a restructuring practitioner or liquidator is likely to remove the trustee with the trustee remaining only as a bare trustee with no right to be able to deal with the assets unless the practitioner goes to the Court for appointment as a court appointed receiver.

Streamlined insolvency process

- Who will fund insolvency practitioners to liquidate small business who meet the definitional requirements but whose realisable net assets are insufficient to meet the practitioners' reasonable costs as these business should be liquidated and not able to continue to operate in a 'zombie' state.
- What are the proposed arrangements for recovering potential preference claims – we recommend that, following meeting the definitional requirements, liquidators should only be able to pursue related party transactions incurred within the 2 years prior to appointment to minimise 'asset stripping' and potential phoenix activity. Liquidators' recovery powers should not be able to pursue payments made to unsecured, partially secured or secured non-related creditors within at least 12 months of the appointment date.
- What is the process to minimise potential phoenix activity by recent directors. In addition, we propose that no-one can seek to use the streamlined insolvency process if they have been a director of a company less than 6 months prior to the proposed commencement date.

2. *If creditors choose not to approve a restructuring proposal, the company should move to liquidation, not voluntary administration as proposed*

In order to ensure integrity in the process and prevent arbitrage or small business 'gaming' creditor appetite, if a small business does not present its best alternative solution, creditors, who by majority, choose not to approve a restructuring proposal, should move the company to liquidation, not voluntary administration as proposed.

3. *Improve financial literacy of small business owners*

The proposed timeframe for new legislation to be enacted is very tight. In parallel to drafting regulations, an extensive education and financial literacy program of small business owners and their financiers needs to occur to maximise the success of the change.

AFIA is happy to lead and work with associations such as the ABA, ARITA, AICM as well as other key stakeholders such as the ASBFEO, ACCI, COSBOA and CAFBA[1] on a key fact sheet and plain English template documents.

4. *Undertake an informal review of the effectiveness of the changes after 9 months of operation and a formal review commencing 1 July 2022*

As above, the timing of the commencement of the reforms is compressed. The reforms are a significant change to the current regime and we hold concerns that there is insufficient time to educate small business and other key stakeholders and upskill practitioners on the new legislation as well as upgrade systems and processes to allow for electronic voting and communications.

We therefore recommend an initial review of the process occurs after 9 months focusing on:

- The number of businesses using the new processes
- Whether the processes are working from the perspectives of insolvency practitioners, businesses and secured and unsecured creditors

We recommend that the Minister for Employment, Skills, Small and Family Business lead that review. We recommend a further deeper dive occur commencing 1 July 2022.

5. *Ensure a robust certification process is in place to become a Restructuring Practitioner*

In order to maximise the success and take up of the process, we recommend that Restructuring Practitioners needs to be at least Registered Liquidators. Without this, the regime risks not being seen as balanced and credible.

Given the compressed timeframes to operationalise these changes, we look forward to working closely with Treasury on the next iteration of the Exposure Draft as well as the Regulations.

If you have any questions, please give me a ring.

Yours sincerely

Karl Turner
Executive Director, Policy & Risk Management

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[1] Australian Banking Association (ABA), Australian Restructuring Insolvency and Turnaround Association (ARITA), Australian Institute of Credit Management (AICM), Australian Small Business and Family Enterprise Ombudsman (ASBFEO), Australian Chamber of Commerce and Industry (ACCI), Council of Small Business Organisations Australia (COSBOA) and Commercial and Asset Finance Brokers Association of Australia (CAFBA).

ATTACHMENT A: AFIA BACKGROUND

The Australian Finance Industry Association (AFIA) is the voice of a diverse Australian finance industry.

AFIA represents over 100 providers of consumer, commercial and wholesale finance in Australia, which includes:

- Major, regional and mutual/community owned banks
- Providers of consumer finance, including home loans, personal loans, consumer leases, credit cards, buy now pay later services, and debt purchasers
- Providers of land finance, including residential and commercial mortgages and bridging finance
- equipment financers, including commercial equipment financing ranging from agri-equipment to small ticket equipment financing
- Motor vehicle financiers, including consumer motor finance, novated motor finance, small business motor finance and heavy vehicle finance
- Fleet leasing and car rental providers, and
- Providers of commercial finance, including secured and unsecured loans and working capital finance to businesses, including small businesses.

AFIA's members range from ASX-listed public companies through to small businesses providing finance, which operate via a range of distribution channels, including through 'bricks and mortar' premises (physical branches and other outlets), via intermediaries (including finance brokers, dealerships, retail suppliers), and through online access or platforms (traditional financial institutions and fintechs).

AFIA's members collectively operate across all states and territories in Australia and provide finance to customers of all demographics from high to low-income earners and to commercial entities ranging from sole traders, partnerships and across the corporate sector in Australia.

AFIA's members provide a broad range of products and services across consumer and commercial finance, a snapshot of these include:

- Consumer: home loans, personal unsecured loans, revolving products (including credit cards and interest free products coupled with lines of credit), personal secured loans (secured by land or personal property); consumer leases of household assets (including household goods, electrical/IT devices or cars) and buy-now, pay later services.
- Commercial: land, asset or equipment finance (finance/operating lease, secured loan or hire-purchase agreement or novated leases); business finance and working capital solutions (secured loans, online unsecured loans; debtor and invoice finance; insurance premium funding; trade finance; overdrafts; commercial credit cards), together with more sophisticated and complex finance solutions.

For further information about AFIA, please see here.

ATTACHMENT B: KEY RECOMMENDATIONS

AFIA is very supportive of these insolvency reforms. We appreciate that many elements of the reforms will be within the yet-to-be released regulations and therefore our comments and recommendations below are designed to assist Treasury in formulating those regulations.

No	Topic	Key Issues	AFIA Comments/Recommendations
1	New Debt Restructuring Process	*Eligibility Criteria* We understand that eligibility criteria needs to be met for a business to access the New Debt Restructuring Process. We note with respect to the eligibility criteria that the regulations will prescribe the total liabilities seeking to enter into the process and how these liabilities will be calculated, however we note: 1. It is likely that businesses with liabilities of up to $1million will be able to access the scheme. 2. We note that regulations will also prescribe requirements around statutory lodgments and payments i.e. employee entitlements and tax lodgments.	• 78% of businesses in insolvency have liabilities of under $1million. • We suggest that $1million in liabilities suggests a business that has complex liabilities which would take a significant time to unwind and may not be practically achievable within the 15 days allocated to formulate a plan. • We therefore recommend a lower threshold of $500,000 or AFIA can work with its members to better understand the average debt of small busines and provide a more informed threshold Protection of employee entitlements is an important element of this regime. ***We recommend that flexibility be provided and access to the scheme is permitted if that the business has sufficient cleared or reasonably cleared funds to meet all outstanding employee entitlements*** We note that having all tax liabilities are paid may not be practical for small business but that it is

No	Topic	Key Issues	AFIA Comments/Recommendations
			important for those businesses to ensure that at least statutory lodgments are up to date.
		Running the company – ordinary course of business We understand Restructuring Professionals facilitate and assist the Debt Restructuring plan developed by Directors. As part of this, there is essentially a stay on payments to creditors during the 15-day period in which the plan is formulated, and the further 10-day period during which creditors are considering the plan. We also understand that the business can continue to trade "in the ordinary course of business" with transactions not in the ordinary course of business e.g. asset and share sales requiring the consent of the Restructuring Professional. During the stay period there may be circumstances where unpaid suppliers may use influence (for example withholding supply) to obtain payment, thereby disrupting the hierarchy of payments and the restructuring planning process. It therefore becomes critical to define or at least provide further examples of transactions that can (or cannot) be entered into during the umbrella of the ordinary course of business.	**As part of the regulations, we *recommend therefore that the following key issues be addressed:*** • ***Who is responsible for meeting debts incurred during this process – noting, at present, an insolvency practitioner is accountable for all debts incurred post appointment after relevant decision periods*** • ***Do debts incurred as part of this process need to be paid in priority to debts at appointment – i.e. is this equivalent to an 'informal' standstill amongst secured and unsecured creditors. As part of this, how will the interests of lenders who provide balance sheet finance (with charges over assets such as stock, debtors, creditors) be dealt with and preserved.*** • ***Who is captured by the 50% approval regime – is this just unsecured creditors or the unsecured excess over debt of secured or partially secured creditors and if the later, how is this calculated – especially if secured creditors cannot realise assets during the restructuring period.***

No	Topic	Key Issues	AFIA Comments/Recommendations
			• ***How will the Restructuring Practitioner consent to asset sales, including any obligation to value assets similar to s420A of the Act. Strong controls and oversight from well qualified Practitioners need to be in place when allowing assets to be sold or asset sale transactions to be entered into during the restructuring period. If this does not occur, credibility in the Scheme will be compromised and future willingness of lenders to approve other Restructuring Plans will be undermined.*** • ***What is the process to allow the Restructuring Practitioner to consent to a secured party exercising its security interest during the restructuring period*** • ***How are contingent personal guarantees captured or calculated and how are creditors who purchase debt dealt with*** • ***What is the position of outstanding taxation liabilities – as we currently understand the process, taxation lodgments need to be up to date but this does not mean that all outstanding taxation commitments need to be met prior to entering into a new debt restructuring process. (Please note that the proposed approach may prevent companies,***

No	Topic	Key Issues	AFIA Comments/Recommendations
			whose debts comprise predominantly of taxation debts, from accessing this process which could be to the benefit of creditors as a wider body.) • ***How do superannuation entitlements fit into the proposal? We propose that they are captured in a similar manner to outstanding tax liabilities i.e. lodgments not payments need to be up to date*** • ***As part of proposal, do all creditors agree to enter into a standstill in that 35 days?*** • ***What are further examples of payments made in "ordinary course of business" - paragraph 1.57 of the Explanatory Memorandum*** • ***How will the rights of creditors not contacted or identified in the process be managed. To prevent potential misuse of the system, by not disclosing some of the company's creditors, other notifications methods including requiring notification to be made on the company's website etc. should be considered*** • ***What is the process to minimise potential phoenix activity by recent directors – there should be anti-avoidance provisions to prevent owners from running down company***

No	Topic	Key Issues	AFIA Comments/Recommendations
			assets or transferring them to another company, in order to qualify for the simplified restructuring regime. • ***We understand that a number of small businesses are conducted through trusts. How will the restructuring and streamlined liquidation processes deal with trusts – noting that the appointment of either a restructuring practitioner or liquidator is likely to remove the trustee with the trustee remaining only as a bare trustee with no right to be able to deal with the assets unless the practitioner goes to the Court for appointment as a court appointed receiver.***
		Enforcement rights A fundamental development in Australia in support of both access to finance and of the insolvency regime itself is the Personal Property Securities Act 2009 which provides certainty to those borrowing and lending in Australia as well as secured creditor rights preserved in the *Corporations Act 2010*. In addition, the use of guarantees, whether registered under the PPSA or not, has enabled more small businesses to gain access to credit.	The EM notes that provisions in relation to secured creditor rights during the restructuring process is still being finalised, however the EM suggests that these rights are consistent with the voluntary administration regime. The Regulations should provide clarity on: • How will the registration of security in transition interests (i.e. those yet to the be formally registered) be dealt with

No	Topic	Key Issues	AFIA Comments/Recommendations
		We note that these rights allow lenders, including both secured and unsecured creditors seeking to protect their on-going extensions of credit, to be confident in providing credit to small businesses.	• What are the rights and remedies available to secured and partially secured creditors during this process – it seems the voluntary administration provisions will prevail but these do not impose requirements to formally approve proposed terms of a Deed of Company Arrangement and secured creditors are bound only to the extent their debt exceeds the value of their security interest • How does this include learnings from the evolution of Debt Agreements to ensure that there are protections in place to reduce the risk that companies (and their directors) commit to restructuring plans that go for too long (we recommend a maximum of 3 years be adopted) or to payment levels beyond which are feasible ***We recommend proposed Regulations ensure the current security hierarchy (i.e. rights and remedies available to:*** • ***PPSR registered security*** • ***Secured creditors*** • ***Partially secured partially secured (i.e. say through charges over soft assets such as stock, debtors and creditors)***

No	Topic	Key Issues	AFIA Comments/Recommendations
			• ***Pursue a guarantee of a liability of the company outside of the initial 35-day restructuring period)*** ***is not materially disrupted from current insolvency law as this could impact on the balance of creditor and debtor (small business owners) rights and domestic and international funding markets who rely on this hierarchy to right price small business facilities.*** ***Creditors (whether secured or not) must be able to continue to enforce rights and remedies against guarantors and directors who are joint and severally liable after the restructuring period has ended, consistent with the current Voluntary Administration process.***
		Voting Commentary indicates that at least 50% of creditors are required to approve the plan for the plan to come into effect. We note that there are no details around how voting is calculated (i.e. if there is a ranking in terms of debt, treatment of related party and secured debt etc.).	***We recommend that voting is by way of $ value and clarity is provided as to:*** • ***Who is captured by the 50% approval regime – is this just unsecured creditors or the unsecured excess over debt of secured or partially secured creditors and if the later, how is this calculated – noting that if secured creditors cannot realise assets during the restructuring period.***

No	Topic	Key Issues	AFIA Comments/Recommendations
			• ***How are contingent personal guarantees captured or calculated and how are creditors who purchased debt dealt with***
		Terminating a debt restructuring process or if the plan is rejected by creditors We note that the EM provides for specific circumstances where the Restructuring Practitioner can terminate the restructuring process including if the practitioner believes the plan is not in the best interests of the creditors. The EM does not provide for what happens after the process is terminated or the plan is rejected. Presumably, the appointment of the practitioner indicates that the business is insolvent and therefore should not be handed back to directors.	We suggest that if a plan fails or is terminated, that this suggests that agreement from creditors was not able to be achieved and further that the business is not viable. We do not agree that the company should have the right to opt for a Voluntary Administration after a failed restructuring proposal. A Deed of Company Guarantee following a VA is unlikely to be successful if creditors have not accepted a restructuring proposal – as noted above, creditors should have the right to place a company into liquidation when they vote on the proposal. A liquidator can then make a decision if something else should be done to save some or all of the business. ***As such we recommend that if the proposal fails, the business is placed into liquidation, bypassing the voluntary administration process.***
2	Simplified Liquidation Process	*Eligibility Criteria*	***To minimise potential phoenix activity by recent directors, we recommend that no-one can seek to use the streamlined insolvency process if they***

No	Topic	Key Issues	AFIA Comments/Recommendations
			have been a director of a company less than 6 months prior to the proposed commencement date
		Preference claims	***We recommend that, following meeting the definitional requirements, liquidators should only be able to pursue related party transactions incurred within the 2 years prior to appointment to minimise 'asset stripping' and potential phoenix activity.*** ***Liquidators' recovery powers should not be able to pursue payments made to unsecured, partially secured and secured non-related creditors within 12m of the appointment date***
		Risks with lack of take up of simplified liquidation process We suggest that with the COVID-19 crisis the numbers of companies with little or no assets will be higher and it is proposed that given under the reforms there will be reduced circumstances in which a liquidator can seek to clawback an unfair preference, due to lack of funding, liquidators will be reticent to apply the process.	***We recommend that Government set up a fund to cover the costs of practitioners to liquidate small business who meet the definitional requirements but whose realisable net assets are insufficient to meet the practitioners' reasonable costs as these business should not be allowed to continue in a 'zombie' state***