12 October 2020

Honourable Josh Frydenberg MP
Treasurer

By email to MCDInsolvency@Treasury.gov.au

RE: Corporate Insolvency Reforms Exposure Draft[1] (**Draft Reform Bill**): Request for Extension of Consultation Period and General Comments

Dear Honourable Josh Frydenberg MP:

Thank you for proposing the much-needed reforms that the Draft Reform Bill will bring to Australian insolvency law, most notably the reforms to introduce a restructuring regime (the '**Restructuring Regime**') that is intended to allow businesses eligible for the regime ('**eligible businesses**') a more viable opportunity to continue in operation. The reforms are particularly necessary '*in light of the economic consequences of Coronavirus and the increase in numbers of business facing financial distress.*'[2] Given the importance of the Draft Reform Bill to eligible businesses and, in turn, to the entire Australian economy, I respectfully offer the following comments for consideration as part of the consultation on the bill.

I. **Extend the consultation period for at least 14 calendar days**. Given the importance of the Draft Reform Bill, the consultation period should be extended from its current five-day comment window (closing 12 October 2020) for another 14 calendar days. The Draft Reform Bill appears to be an attempt to add restructuring mechanics adopted from Chapter 11 of the United States' Bankruptcy Code[3] ('**Chapter 11 Mechanics')** that allow the board of directors to remain largely in possession of the debtor-business, which would tend to allow for the retention of the native expertise of the business facing restructuring. Such possible reforms have been considered for decades,[4] however, these reforms are justly impelled at this time due to the crisis that Coronavirus has created. Nonetheless, the reforms present a dramatic paradigm shift for Australia from (A) the current system which is focused on moving power over the insolvent business to its creditors to (B) a new system that would leave in place the insolvent business's board of directors, which board could be

1 Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 (Cth).
2 Exposure Draft Explanatory Materials, Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 (Cth) (the **'Explanatory Materials**').
3 11 USC ch 11, ss 101 et seq.
4 See e,g, L Griggs, "*Voluntary Administration and Chapter 11 of the Bankruptcy Code (US)"*, (1994) 2 Insolv LJ, (1994) 93 at 94.

expected to retain much of the insolvent business's management. This paradigm shift will directly impact creditors, shareholders, employees and other stakeholders, such as the surrounding communities and their local governments. All interested parties deserve a meaningful opportunity to understand the Draft Reform Bill, consider how it may impact their interests and provide reasoned comments to elucidate Treasury on how the bill will impact them. A 14-day consulting period extension would balance the obvious need for quick reforms in light of the crisis with the equally important needs for the reforms to be effective and to minimise unintended consequences.

II. **The following changes should be made to the Draft Reform Bill to maximise its effectiveness and minimise unintended consequences**. Ideally an extension of the consulting period would be granted to allow interested parties to review and comment on the Draft Reform Bill as discussed in **Part I**, however, should such an extension not be possible, at a minimum the following changes should be made.

a. **The reported liability cap for eligibility for the Restructuring Regime should be eliminated or at least greatly increased**. The Draft Reform Bill specifies that the '*where the regulations prescribe a test for eligibility based on the liabilities of the company — that test*' must be satisfied on the day that a small business registered practitioner ('*SBRP*') is appointed.[5] The test based on liabilities is reportedly $1 million.[6] While it is understood that the intent is to limit the Restructuring Regime to small businesses,[7] it is submitted that the experience in the United States proves that such a tepid approach to introducing Chapter 11 Mechanics is not warranted where the scheme has been in place essentially in its current iteration since 1978. This is particularly so at this time when some have estimated that '*tens (if not hundreds) of thousands of small businesses…will fail once COVID-19 support by the government is wound back'* in Australia.[8] Accordingly, it is submitted that:

i. **First, there should be no liability cap**. Removing a liability cap will make the Restructuring Regime available to all companies in Australia. While such an approach may seem radical, the experience in the United States demonstrates that the approach is systemically safe and, given it would be

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5 Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 (Cth) s 453C(1).

6 See, eg, Melissa Clarke, 'Federal Government to adopt US-style insolvency rules to help with unexpected wave of business closures, says Treasurer Josh Frydenberg', *ABC News* (online), 23 September 2020 <https://www.abc.net.au/news/2020-09-23/government-to-boost-support-for-businesses-facing-closure/12694904>.

7 Exposure Draft Explanatory Materials, Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 (Cth) 6.

8 Jason Harris, 'A new system for SME restructuring: is there a business doctor in the house?' *Australian Insolvency Law* (online), 9 October 2020 https://australianinsolvencylaw.com/2020/10/09/a-new-system-for-sme-restructuring/.

available to all companies, would maximise the chances of saving companies in Australia including the associated jobs and minimising the impacts on many of the stakeholders.

ii. **As a second-best approach, any liability cap should be expressed as a percentage of the business's retained deficit as of the date of testing rather than as an absolute value**. Regulations should set any such cap and provide for it to be adjusted from time to time based on practical experience. Such an approach would, as with the first recommended approach, make the Restructuring Regime available for all companies irrespective of size but effectively limit the amount of risk the regime is creating by such a cap.

iii. **As a least-favoured approach, the liability cap should be supplemented with an alternative test of eligibility based on annual turnover of $10,000,000 or less**. This approach would correspond with the current approach of the Australian Taxation Office, which provides that an entity is a small business if it has a turnover of such an amount or lower.[9] The benefit of the approach would be to increase the size of the pool of eligible businesses for the Restructuring Regime while adhering to the Treasury's stated goals of limiting eligibility to small businesses. For clarity, it is submitted this should serve as an alternative (meaning disjunctive) test of eligibility to the liability cap.

b. **Eliminate the requirement for an SBRP for entities with fewer than $500,000 in liabilities and provide regulatory flexibility for further exemptions from SBRP requirements**. Engaging an SBRP will result in incremental costs, which costs may prove prohibitive to a small business that may otherwise benefit from the Restructuring Regime. Accordingly, a small business that may be otherwise capable of surviving by virtue of the regime may instead determine to go into liquidation resulting in unnecessary bad impacts on the associated stakeholders including loss of the associated employment. It is submitted that for very small businesses, an SBRP is unnecessary to provide a check on a proposed restructuring plan, which plan would still be subject to approval by the company's creditors. Likewise, if a company has a limited number of creditors, it is submitted that there should be a regulatory exemption from the SBRP requirement as the

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9 Australian Taxation Office, *Work out if you're a small business for the income year*, < https://www.ato.gov.au/Business/Small-business-entity-concessions/Eligibility/Work-out-if-you-re-a-small-business-for-the-income-year/#estimated_current_year>.

advisory nature of the role may not be warranted. In such cases, these businesses should have the option of engaging an SBRP but not be required to do so.

c. **Eliminate the requirement that an SBRP consent to a transaction not in the ordinary course of business**. The Draft Reform Bill provides that transactions not in the ordinary course of business are voidable and could present directors with civil and criminal liability.[10] It is submitted that this requirement will impede, if not prevent, transactions from occurring that would otherwise result in the survival of the entity using the Restructuring Regime. Given the risk of such liability, directors are likely to err on the side of caution and seek consent of the SBRP for all but the most routine of transactions. However, depending on the nature of the business, time spent in seeking and receiving SBRP consent is certain to result in lost commercial transactions that would otherwise have been to the benefit of all of the business's stakeholders.

d. **Restructuring plans should only be subject to consent by impaired classes of creditors**. The Draft Reform Bill provides for consent rights by all classes of creditors,[11] however, as with the Chapter 11 Mechanics in the United States,[12] the only class of creditors that deserves consent rights is a class that will not receive the full value of what is owed to it, ie, an impaired class. This approach minimises the parties to the negotiation of a restructuring plan to those with a certain interest in the outcome and removes those who will be fully repaid having the effect of making reaching an agreement more likely. By the same token, if a single impaired class accepts the restructuring plan, the Restructuring Regime should replicate the cram-down Chapter 11 Mechanics, meaning a court can approve the plan over objecting creditors in such an instance.

e. **Replicate Chapter 11 mechanics that ensure a market for debtor-in-possession financing develops**. Critical to the success of the Restructuring Regime will be to ensure that providers of credit to the debtor-in-possession company can receive new loans with priority over existing creditors, as with Chapter 11 Mechanics.[13] This lending regime must capture the key elements of those Chapter 11 Mechanics to give lenders adequate comfort to make such loans, which will be critical to the business's survival.

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10 Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 (Cth) ss 588FE(2D)(d), 588GAAB(1).

11 Exposure Draft Explanatory Materials, Corporations Amendment (Corporate Insolvency Reforms) Bill 2020 (Cth) 10 [1.8].

12 11 USC s 1129(a).

13 11 USC s 501 et seq.

Thank you for the opportunity to comment on the Draft Reform Bill. I can be reached at any time on my contact information below my signature.

Yours sincerely,

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