Manager
Market Conduct Division
Treasury
Langton Crescent
PARKES ACT 2600

MCDInsolvency@treasury.gov.au

Grant Thornton Australia Limited
Collins Square
Tower 5
727 Collins Street
Melbourne VIC 3008

T +61 3 8320 2222

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Dear Sir/Madam

Submission in relation to "Insolvency reforms to support small business"

Thank you for the opportunity to provide our submission in relation to the proposed reforms.

About Grant Thornton

Grant Thornton Australia is a single nationally integrated firm. We are a member firm of Grant Thornton International, a global network of Grant Thornton firms with over 50,000 people and a presence in 135 countries.

Grant Thornton Australia has more than 1,300 people working in offices in Adelaide, Brisbane, Cairns, Melbourne, Perth and Sydney with expertise across 5 service lines and 13 industry specialisations. Our restructuring team consists of 11 Partners (including 10 Registered Liquidators and 2 Registered Trustees) and 70 professional staff.

Our Partners and Directors are members of the leading industry bodies representing insolvency and restructuring, including the Australian Restructuring, Insolvency and Turnaround Association (ARITA), the Turnaround Management Association (TMA), and INSOL. Our Partners have held senior roles in these industry associations including as a Past President of ARITA and Committee roles with both ARITA and the TMA.

Our key observations

Many of the points made in our submission are framed in the form of questions. This is in part due to the fact that much of the detail supporting the reforms is yet to be provided, and this has limited our ability to comment fully on the likely practical implementation of the proposed reforms. We expect this detail will ultimately be presented, either by incorporation into the Act or into the Regulations, following a further consultation process with the industry prior to 1 January 2021.

Having considered the *Exposure Draft Bill* released on 7 October 2020 and the *Fact Sheet* released by the Treasurer on 24 September 2020, we make the following comments and observations:

1. We welcome the requirement that the restructuring practitioner must be a registered liquidator (s456B). The integrity of the proposed reforms, and the confidence of stakeholders in the new restructuring process, relies on having a suitably qualified and experienced professional consent to the appointment as the restructuring practitioner. Registered liquidators satisfy those critical requirements.
2. We caution that the qualifications and requirements of any new category of registered liquidator, should this be contemplated as part of the reforms, must be carefully considered so as to avoid the same risks and issues that have arisen in some cases as a result of the much broader parameters available for parties to qualify as a Safe Harbour advisor.
3. We observe that the new process supports a balance sheet or financial restructure of a small business, as opposed to an operational restructure. Under the restructuring plan the company has an opportunity to compromise its debts, with the agreement of creditors, in order to enable the business to continue to trade with less debts. However, we note that businesses in the hardest hit sectors (hospitality, tourism, retail, events and gyms) are likely to require more assistance immediately in order to be viable; for example, they may require steps to be taken in relation to operational restructuring (i.e. a terminated or renegotiated lease on fundamentally different terms, or a right-sizing of the workforce) in order to demonstrate sustained viability. Many small businesses will not have access to the necessary advice and support to implement an operational restructuring, and this is likely to become a consideration for creditors when deciding whether to support a restructuring plan.
4. There exists in Australia an element of distrust with existing management when a company enters any form of insolvency process. *Why hand the keys back to the person who crashed the car?* In a voluntary administration scenario, the requirement for an independent insolvency practitioner to be appointed, along with the personal liability that resides with the practitioner for debts properly incurred post appointment, provides a level of guarantee to trade creditors and suppliers so that they can continue to supply, on credit terms, to the business during administration with the security that they will paid. Under the new reforms, unlike a voluntary administration, there is no statutory guarantee provided by the restructuring practitioner – creditors are relying on the company and its directors who are responsible for continuing to make payments for debts incurred during the restructuring process. This is a leap of faith for Australian businesses, no form of debtor in possession (DIP) process exists under Australian law and the appetite for creditors to support a DIP process has not been tested before now. We expect that many trade creditors and suppliers will cease supplying on credit terms during a restructuring process absent a guarantee from the restructuring practitioner - who we note is also a registered liquidator and is ordinarily subject to rigorous qualification, education and registration requirements, as well as being required to have in place appropriate insurance. As a consequence, the ability of a small business to fund ongoing trading during the restructuring process, partially or substantially on a cash on delivery (COD) basis if required, is questionable. The risk this exposure presents to suppliers and creditors, and the steps they may necessarily take to protect themselves from incurring further debt, will inhibit many typical small businesses being able to continue to operate and preserve value in the short term whilst a plan is formulated for consideration by creditors.
5. We can foresee issues arising in relation to the supply of inventory by secured parties (i.e. suppliers of inventory holding registered security interests on the PPSR). Similar to a voluntary administration, these secured parties are restricted from taking possession of their inventory during the restructuring (s453(Q)(3)). Unlike a voluntary administration, and as noted above, PPSR secured parties cannot rely on the statutory guarantee provided by a voluntary administrator in relation to inventory used or sold during the restructuring period. It appears the supplier must 'cross their fingers' and hope the restructuring plan is successful and that they are ultimately paid for the inventory used during the restructuring period. For businesses that are 'in the zone' of insolvency, where the appointment of a restructuring practitioner may be imminent, suppliers may try to pre-empt the process and take steps to recover inventory to protect their position. This is likely to disrupt the ongoing trading of the small business and may prove fatal to any restructuring plan, making it unworkable from the outset.

6. We consider it is likely in many situations that directors of insolvent entities may *not* be motivated to declare an ‘intention to access the simplified restructuring process’ up to 3 months prior to an appointment, a course of action that may otherwise allow directors to avail themselves of the protection from insolvent trading. Doing so will alert suppliers and creditors who, for the reasons highlighted above, may then take pre-emptive steps to recover inventory or other assets prior to the commencement of the restructuring. This is because the restrictions in relation to PPSA secured parties seeking to recover inventory or other property that exist under the restructuring process (s453Q), as well as in a voluntary administration, do not appear to be place during the 3 month period after a director declares an ‘intention to access the simplified restructuring process’. Our view is that the issue of insolvent trading is generally not a major consideration for most directors of small businesses, therefore they may be less inclined to avail themselves of the opportunity to ‘declare an intention’ if it presents a risk to the business.

7. An important question that requires clarification relates to the $1million debt threshold for a company to qualify for a restructuring.

   a. Does the threshold include unsecured debts only? For completeness, are all secured debts included?

   b. Are related party claims included in the threshold test? We understand that a subsequent vote by creditors on the restructuring plan will exclude related party creditors for voting purposes, but are those related party claims included in the threshold test for the purposes of the company qualifying for the restructuring process in the first place?

   c. Are employee claims included in the threshold test? If so, does this include only ‘on balance sheet’ entitlements such as leave entitlements? Or are termination entitlements also included in the threshold test given the company must be insolvent to qualify for the restructuring process?

   d. Are contingent claims included and at what value? For example, a liability in relation to the unexpired portion of a lease.

8. There does not appear to be any requirement for the restructuring practitioner, in certifying the plan, to provide creditors with a comparative outcome under a liquidation scenario (i.e. when compared to the proposal under the restructuring plan). Without a comparative, creditors may be inclined to reject the plan rather than approving the restructure and then suffering what will in many cases will be a material compromise on their claims. We note that a compromise is also likely in liquidation, but inherent suspicion and a lack of investigation into the causes may mean creditors elect not to give the directors a second chance. In any case, we consider that the ability of the restructuring practitioner to assess an alternate liquidation outcome will be limited by the absence of a duty to investigate and form a view on a number of considerations that are otherwise present in a voluntary administration; causes of failure, director misconduct, the collectability of related party loans, the potential for uncommercial transactions, or preferential payments that could otherwise be available to creditors in a liquidation. These limitations, and a lack of visibility regarding alternate outcomes for creditors, create uncertainty and are likely to impact creditors in deciding whether to support the plan.

   We appreciate there is a trade-off between seeking to mitigate the cost of the restructuring process, whilst being able to provide creditors with sufficient information to make an informed decision. It appears that the regulations will be instructive in relation to the administrative and reporting burden on the practitioner, which will in turn be a key factor impacting the cost.

9. In respect to voting on the restructuring plan:

   a. Will there be one class or multiple classes of creditors voting?

   b. Is the required threshold >50% of all creditor claims in order to accept the restructuring plan? Or is it 50% of creditors who choose to vote on the plan? We expect that some creditors, for example banks and other secured lenders, may elect not to vote.

10. Under the new restructuring process, there is no meeting to consider the restructuring plan and therefore no ability for creditors to ask questions, challenge elements of the plan, or to request amendments to the plan in that forum - it appears to be a take it or leave it proposition for creditors.

11. As referenced earlier, clarity is required regarding the status of any debts incurred during the restructuring period (indicatively 35 business days).

    a. Are the debts incurred during this required to be paid in the ordinary course?

    b. Or are these debts incorporated into the plan and paid on a pari passu basis along with other pre-restructuring creditors?

    Consideration may be given to providing a form of priority, should the plan ultimately be approved, for suppliers and creditors who continue to support the business during the restructuring period prior to approval of the plan.

12. Most small businesses will have limited access to funding in the period prior to, and during, a restructuring process, and it follows that there will be significant commercial pressure to defer payments such as PAYG, GST and other statutory obligations in the lead up to the restructuring period in order to free up cash to fund the continued trading of the business. What is the priority status of statutory liabilities that accrue during the restructuring period? In our assessment, including for the reason just mentioned, it is likely that the ATO will be a dominant creditor in many small business restructurings. Has this been considered and will the ATO have a stated position on how it intends to approach small business restructurings, including in relation to voting on restructuring plans?

13. What is the level of involvement of the restructuring practitioner in the *development* of the plan?

    a. Is the restructuring practitioners' role limited to reviewing and certifying the plan presented by the company to the practitioner?

    b. Or is the restructuring practitioner expected in some cases to be the architect of the plan in consultation with the company? We note that the level of sophistication and available expertise in small businesses will be limited in many cases in order to support development of a plan by the company.

14. One of the functions of the restructuring practitioner is to "to make a declaration to creditors in accordance with the regulations" (s453E(1)(c)).

    a. As part of the certification process, will the restructuring practitioner be required to make an assessment as to whether the business will be viable in the future, following the restructure?

    b. What protection is provided to the restructuring practitioner in relation to any certification or declaration provided in relation to the restructuring plan? We query whether the liability limitations in s456H go far enough to protect the restructuring practitioner, and we believe this protection should be expanded.

    c. We expect the restructuring practitioner will have limited information to consider within a tight timeframe in order to form a view - so clarity is required regarding what recourse, if any, creditors or other interested parties may have against the restructuring practitioner.

    d. Pursuant to Section 453M(b), we note that the restructuring practitioner may be required to approve payments or transactions during the restructuring period. Is this limited to payments in the ordinary course of business? If so, it appears inconsistent with the debtor in possession intention of the reforms.

15. The *Fact Sheet* states that the practitioner will propose a <u>flat fee</u> for helping develop the restructuring plan. Further clarity is required in relation to the role of the practitioner, including the administrative and statutory obligations which are likely to have a material impact on the practitioner's costs. In relation to management of the plan, the *Fact Sheet* suggests the

practitioner will propose a fee 'which will operate as a percentage fee of disbursements made under the plan'. This places the practitioner in a position of conflict - their fee is directly linked to the quantum of funds offered to creditors under the plan, in circumstances where the practitioner's role is to then certify the plan. We also note that the practitioner has the ability to terminate the restructuring plan under s453J. What priority will be afforded to the practitioners fees, both for helping develop the plan, and then in relation to management of the plan?

16. What is the role of the Court, if any? Section 458A provides the Court with powers to vary or terminate the plan or to declare it void. What other role or oversight does the Court play in the process?

17. Does a company have the ability to appoint a restructuring practitioner after a winding up application has been filed? If so, what is the impact on the pending application?

18. In many cases, the books and records of an insolvent small business are poor. In our experience, it can take some time for a practitioner to gain clarity regarding the true quantum of claims by creditors, and often only after a formal adjudication process. We can foresee instances where a company *appears* at first observation to meet the threshold test in order to qualify for the restructuring process by having debts less than $1million, either because of poor record keeping which does not reflect the true creditor position, or where opportunities have been taken for manipulation of the company's books and records in order to meet the threshold.

    Where the restructuring practitioner subsequently believes that the relevant debts are greater than $1million, is the restructuring practitioner then obliged to terminate the process – presumably under s453J? Is there any recourse to the restructuring practitioner for accepting an appointment based on the limited information available and the representations of the Director and the Company? Or will discretion be allowed to continue the process if the restructuring practitioner believes the plan is likely to result in a better outcome? Similar considerations to those relating to Safe Harbour could be contemplated here, but we note there are limitations regarding comparative outcomes which are discussed in this submission.

19. In respect to the proposed streamlined liquidation process, we are supportive of the introduction of a more streamlined liquidation process for small business. However, we consider that the proposed threshold of $1million in liabilities is too high, as this encompasses a large volume of liquidations where there are relatively material debts owing to many individuals and small businesses – those creditors are entitled to some accountability, and to see an independent liquidator appointed with obligations to investigate past conduct and report to ASIC under s533 (or a similar provision). We suggest a lower threshold of no more than $500,000 in total liabilities is more appropriate for a streamlined liquidation.

We welcome the opportunity to discuss the practical implementation of the proposed reforms with the Government. We believe that the intention of the reforms represents a positive, constructive pathway for small business to restructure their debts and provides an opportunity to preserve value in small businesses where possible with the support of creditors.

Yours sincerely
Grant Thornton Australia Limited

Greg Keith
CEO, Grant Thornton Australia

email: greg.keith@au.gt.com

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