Mendelsons
National Debt Collection Lawyers

PRU$HKA
FAST DEBT RECOVERY
NO RECOVERY – NO CHARGE

Insolvency Reforms to Support Small Business
Submission by Prushka Fast Debt Recovery Pty Ltd ("Prushka") and Mendelsons Lawyers Pty Ltd ("Mendelsons")

DETAILS OF THE PARTIES MAKING THE SUBMISSION

1. Prushka has been in business as a debt recovery agency since 1977.

2. Prushka acts for in excess of 58,000 SME businesses across Australia and from all industry types as well as a smaller number of larger corporate clients including lenders to SMEs. In such capacity, Prushka deals with more SMEs handling their debt collection work than any other organization in Australia and as such sees the industry from the position of being right at the coal face.

3. Mendelsons is the debt recovery law firm directly associated with Prushka and it handles all its legal work, Australia wide, relating to debt collection, insolvency work on behalf of liquidators and bankruptcy trustees and legal enforcements.

4. This submission is written by Roger Mendelson, director of Prushka and Principal of Mendelsons, Alison Lee, Special Counsel and Practice Manager of Mendelsons and Jason Pomaroff, Senior Associate at Mendelsons.

BACKGROUND

5. The *Corporations Amendment (Corporation Insolvency Reforms) Bill 2020* (**Bill**) introduces various reforms within the insolvency framework which aims to provide new processes for small businesses, reducing complexity, time and costs for small businesses. The changes aim to enable more Australian small businesses that are financially distressed but viable, to quickly restructure and, where restructure is not possible, allow businesses to be wound up faster, enabling greater returns for creditors and employees.

6. The Bill's overall goal is to support Australia to emerge from the pandemic with a stronger, more resilient and more competitive economy.

7. The Bill introduces the following proposed reforms:

   (a) Introduction of a formal debt restructuring process;

   (b) Extended temporary relief for eligible companies intending to undertake a formal debt restructuring process;

   (c) Introduction of a simplified liquidation process for eligible companies in a creditors' voluntary winding up;

(d) Refinements to the requirements for registration as a liquidator; and

(e) The greater use of electronic documents and electronic signatures in an external administration.

8. The proposed measures will commence on 1 January 2021, subject to the passing of legislation.

9. A lot of the detail is not available as they will appear in the rules and regulations that are not currently available for comment and consultation. This means that it is only possible to provide comment on the framework establishing legislation. Until the proposed rules and regulations are circulated, there is a lot uncertainty about what impact the changes will have.

10. On the material made available for consultation, these submissions will focus on the debt restructuring and simplified liquidation processes.

<u>DEBT RESTRUCTURING PROCESS</u>

Eligibility and Utilisation

11. The formal debt restructuring process allows an eligible company to restructure their debts and maximise their opportunity for survival. The process will allow a company director to retain control of their business, and its property and affairs, while developing a plan to restructure their debt with the assistance of a small business restructuring practitioner (**SBRP**).

12. The process is said to be generally similar to the voluntary administration process of the *Corporations Act 2001* (CW) (**CA**) and Part IX Debt Agreements under the *Bankruptcy Act 1966* (CW).

13. The key eligibility criteria suggested in the Explanatory Memorandum (**EM**) for entry by a small business into a debt restructuring process are:

    (a) The company's employee entitlements be paid up to date;

    (b) The company's tax lodgements are up to date; and

    (c) The company's liabilities are less than a prescribed amount (expected to be less than $1 million).

14. We see that the requirements to have employee entitlements and tax lodgements up to date as positive as these facilitate the underlying spirit of the Bill to support viable businesses.

15. We feel, however, that the process will either not apply to many small businesses and/or that many small businesses will not take it up.

16. From working and dealing with small businesses at the coal face, most businesses that are not paying their bills are:

    (a) Not up to date with their employee entitlements and/or tax lodgements; and

(b) Run by individuals, so the debt restructuring process will not even be available to them;

(c) Companies running businesses that have innocently failed; or

(d) Companies that are "defacto phoenixing" where the failure of their business is not intentional, but as it is the director's subsequent company (or one of a multiple of companies), the debts get too high, they cannot pay, the company is left "as is" and another one is started up. This is probably the bulk of the failed businesses that we see. In essence, most of the businesses which fail to pay are hopelessly insolvent and run business models which result in little tax being paid and are probably uncommercial businesses.

17. Given the anticipated $1 million liability threshold, this is also expected to make the debt restructuring process:

    (a) Potentially work well for the small businesses that are on the lower end of the threshold, however, we query how many of them will actually take the time to undertake all of the necessary steps to enter into the process, particularly those that fall into the "defacto phoenixing" category;

    (b) Apply more so to the small businesses at the upper end of the threshold, although these businesses are likely to have more secured creditors which will therefore have an impact on the return to unsecured creditors which, in our experience, will be made up of many other SMEs.

General Comments

18. According to the EM, the following detail will be prescribed by the rules and regulations:

    (a) The detailed requirements relating to restructuring plans including the required content and the circumstances in which it may be terminated, be contravened, or be rendered void.

    (b) The detailed requirements relating to the information, reports and documents that are to be given to the SBRP and the consequences associated with the failure to comply with those requirements.

    (c) How liabilities are calculated, adjudication of proofs of debt, the ranking of debts and any dispute resolution mechanisms.

    (d) Safeguards to protect against the misuse of the restructuring process.

    (e) The functions, duties, and powers of the SBRP.

    (f) The rights and liabilities of the SBRP and whether creditors have recourse against the SBRP for misconduct.

    (g) The effect of a restructuring plan on the right, obligations and liabilities of the parties.

19. At this stage, it appears that within 20 (twenty) business days of entering into the debt restructuring process, the restructuring plan must be sent to creditors who then have fifteen (15) days to vote upon it. Whilst we understand the shortened timeframes are expected to facilitate and streamline the process, we believe that they may be unrealistic and will not provide sufficient time for any necessary information to be considered properly, to enable the required advice to be obtained on such information and then to ensure that all creditors are notified.

20. The insufficient time that an SBRP may have to undertake the required and appropriate level of review of debt restructuring plans and the documents provided in support may lead to SBRPs recommending plans to creditors when the process has already been undermined or influenced or corrupted by the actions taken by a pre-insolvency advisor immediately prior to the commencement of the debt restructuring process. An SBRP may not have sufficient time or resources to fully investigate restructuring plans and protect creditors against misconduct and may inadvertently lend credibility to plans that would not survive further scrutiny.

21. The fines associated for breaching the proposed provisions range between 20 and 50 penalty units and may not be sufficient to deter misconduct. Similarly, it is unclear whether the ASIC will have sufficient resourcing and funding to oversee the restructuring regime and to enforce breaches that occur.

22. A company defaulting on its debt restructuring plan does not immediately appear to be a basis for termination. This may appear in the regulations as a circumstance in which a restructuring plan is terminated or contravened, but these are not currently available for consultation. Currently, it is stated that termination occurs as prescribed in the regulations (which are currently unknown) or when:

    The SBRP for a company under restructuring may terminate the debt restructuring process, at any time, if they believe on reasonable grounds that (Schedule 1, item 1, section 453J(1) of the CA):
    - The company does not meet the eligibility criteria for restructuring;
    - It would not be in creditors' interests to make a restructuring plan;
    - It would be in the interests of creditors for the restructuring to end;
    - It would be in the interests of creditors for the company to be wound up;
    - Any other grounds prescribed by the regulations.

23. Whilst it has not yet been made clear, we expect that as the entering into of the debt restructuring process will be considered to be an act of insolvency, this will allow creditors to proceed with an Originating Process to thereafter wind up the company in the event that the process fails or is otherwise somehow terminated.

24. As there will be a moratorium on the enforcement of personal guarantees, we also expect the time at which creditors will be able to enforce same will be made clear (e.g. once the debt restructuring process has been voted upon, once it has ceased and/or upon its termination). The specificity of the moratorium period is crucial as our experience demonstrates that SMEs grant credit relying on the provision of personal guarantees more frequently than any other manner that might otherwise make them a secured creditor.

25. We expect that SMEs will now start to take steps to minimise their exposure when dealing with companies between now and the legislation coming into effect by requesting security other than guarantees in order to provide (ongoing) credit or to continue to do business with

other SMEs as a manner to protect themselves (i.e. become secured creditors and/or to more readily avail themselves of the provisions of the *Personal Properties Securities Act 2009* (CW)).

26. This action is considered likely as we also expect that companies that already envisage themselves utilising the debt restructuring process when the legislation comes into effect will take steps now to ensure that they will be able to continue to trade when the time comes for the debt restructuring by, for example, buying supplies in large quantities and potentially to the limit of the liability threshold, increasing exposure to unsecured creditors.

27. There does not appear to be an immediate ability for a creditor or group of creditors to replace the SBRP for whatever reason they consider fit. This is particularly concerning if creditors believe that the SBRP's independence is, or is likely to be, undermined.

28. Currently, in terms of the replacement of an SBRP:

    (a) The appointment of a SBRP for a company or a restructuring plan cannot be revoked (Schedule 1, item 1, section 456D of the CA).

    (b) The company may appoint a new SBRP if the original SBRP dies, resigns or becomes prohibited from acting as SBRP. The appointment of the SBRP is to be made by resolution of the company's board (Schedule 1, item 1, section 456(E)(1) to (3) of the CA).

    (c) Alternatively, if the Court appointed the SBRP, then the Court can appoint a replacement SBRP (Schedule 1, item 1, section 465E(2) of the CA).

    (d) The Court may, on the application of ASIC, a company officer, member or creditor, appoint a SBRP to a company that is under a debt restructuring process if that company does not have an acting practitioner (Schedule 1, item 2, section 456E(4) of the CA).

29. It is also unclear as to what happens in the event that a creditor has not been disclosed by the company to the SBRP (or the creditor is unaware of the debt restructuring process for whatever reason) and therefore is unable to participate in the initial voting process and matters flowing thereafter.

30. Some of the more positive aspects of the debt restructuring process are that:

    (a) We acknowledge that creditors may receive more in the dollar compared to if the company was to go into liquidation.

    (b) As per the EM, a payment made, a transaction entered into, or any other act or thing done in good faith by, or with the consent of, the SBRP of a company under restructuring is valid and effectual for the purposes of the CA and is not liable to be set aside in a winding up of the company. This applies in relation to payments, transactions and acts undertaken by the SBRP, by a company under restructuring with the consent of the SBRP, or by a company under restructuring in compliance with an order of the Court. The effect of this is to confirm the validity of certain acts done during the course of the restructuring. The intention of the provision is for it to be relied upon by a person who acquires property of the company during the restructuring (Schedule 1, item 1, section 453M of the CA).

    (c) When a company enters the debt restructuring process it must give notice on all public documents and negotiable instruments that it is under the restructuring process by adding

(“restructuring practitioner appointed”) after the company’s name. This requirement exists for the duration of the restructuring process (Schedule 1, item 1, section 457B and the table in Schedule 3 to the CA).

As it is our experience that many SME creditors do not operate a sophisticated credit checking process, this at least gives them clear notice about the financial position of the business(es) that they are dealing with and can make more informed decisions.

(d) Activities that alter the ownership control of the company, such as transferring or altering the status of shares, when the company is under debt restructuring, are void unless written consent from the SBRP for these changes is provided.

If the SBRP gives conditional consent or refuses to give consent to a transfer of shares, the transferor, transferee or creditors of the company can apply to the Court to set aside the conditions or authorise the transfer.

Again, we see that this transparency can only be for the benefit of creditors and particularly, SME creditors.

SIMPLIFIED LIQUIDATION ROCESS

Eligibility and Utilisation

31. The simplified liquidation process will be available to companies that are expected to have relatively simple affairs, with the total liabilities of the company not to exceed an amount to be prescribed in the regulations and will also only available to:

(a) Creditors’ Voluntary Liquidations (therefore unable to be used for Members’ Voluntary Liquidations or a winding up ordered by the Court); and

(b) Companies where no directors have used the debt restructuring process or the simplified liquidation process previously.

32. Creditors may request a liquidator not to use the simplified liquidation process or a liquidator may decide not to use the process (at which time the existing regular liquidation process will be followed).

33. The key eligibility criteria suggested in the EM to choose a simplified liquidation process are:

(a) The company’s tax lodgements be up to date;

(b) A director of the company must not have previously used the simplified liquidation process and must make a declaration in this regard; and

(c) The company’s liabilities be less than a prescribed amount.

34. Again, we see that the requirement to have tax lodgements up to date as positive as this facilitates the underlying spirit of the Bill. However, this in itself will also eliminate a lot of companies from being able to utilise the simplified liquidation process as our experience is that a lot of companies that fail to pay their debts (regardless of what the prescribed amount

might be) have not complied with their tax obligations. As this more streamlined liquidation process clearly benefits the ATO from the outset, it remains to be seen whether and how it will be a benefit to the creditors generally.

General Comments

35. The simplified liquidation process aims to reduce costs and result in a potentially higher return to the creditors.

36. However, this also means that there is less scrutiny available over the liquidation by creditors than what otherwise exists under the regular liquidation process. As stated in the EM:

    (a) Under a simplified liquidation process, a liquidator may not convene a meeting of creditors at any time, cannot be directed to convene a meeting of creditors by ASIC or by creditors, and is not required to convene a meeting of creditors in certain circumstances.
    - This is different to the current law where the liquidator may convene a meeting of creditors at any time and must also convene a meeting if directed to by ASIC or by creditors or when required in certain circumstances

    (b) Under a simplified liquidation process, creditors may not appoint a committee of inspection to monitor the liquidation and to give assistance to the liquidator.
    - This is different to the current law where creditors of a company in liquidation may decide that there is to be a committee of inspection to monitor the liquidation and to give assistance to the liquidator.

    (c) Under a simplified liquidation process, ASIC and creditors cannot appoint a reviewing liquidator to carry out a review of the liquidation. However, the Court retains the power to appoint a reviewing liquidator. The Court also retains its power to inquire into the liquidation.
    - In addition to the Court being empowered to appoint a reviewing liquidator to carry out a review of the liquidation, creditors and ASIC can also appoint a reviewing liquidator.

37. An advantage to creditors, however, is that creditors may benefit from the amendments to voidable transactions for simplified liquidations. As per the EM, regulations may be made to provide circumstances in which a transaction is not an unfair preference under section 588FA or a voidable transaction under section 588FE of the CA for companies in the simplified liquidation process. For example, regulations could prescribe that, for the purposes of the simplified liquidation process, an unfair preference must relate to a transaction of a certain value or that transaction is voidable only if it occurred in a certain period. The intention of these regulations would be to better target the sorts of unfair preferences and voidable transactions that are available to be pursued in the simplified liquidation process (Schedule 3, item 6, sections 500AE(3)(a) and (b) of the CA).

    We see this as being a positive for many of the smaller SME creditors that we act for.

SUMMARY

38. A very high percentage of corporations which are insolvent are generally not worth saving so these proposed reforms will not affect those companies. However, we feel that even for those that may still be viable, the Bill is not going to make a major difference in saving businesses post JobKeeper and moving forward within and post the COVID-19 pandemic as it is our view that most businesses simply will not qualify or deem it worth their time to go through the process(es).

39. In addition, we see that not many liquidators will be inclined to take on the role as SBRPs due to the unintended consequence of needing to do more due diligence in an apparently more streamlined environment and for the anticipated remuneration which, in itself, will hinder access to the process(es) by small businesses.

40. The Bill represents a laudable attempt to improve insolvency law and processes and will find a place in the economy in the long term. However, due to the high eligibility criteria, the number of businesses which will benefit from the changes will be minimal.

41. We don't advocate lowering the criteria. However, it is unrealistic to think that these changes will make any real impact in reducing the number of business failures which are likely to follow the end of JobKeeper support on 31 March 2021.

Date: 12th October 2020

Contact

Roger Mendelson
Direct: (03) 9872 7229
Mobile: 0438 906 181
Email: roger@mendelsons.com.au

Alison Lee
Direct: (03) 9872 7237
Mobile: 0412 772 232
Email: alison.lee@mendelsons.com.au

Jason Pomaroff
Direct: (03) 9872 7251
Mobile: 0459 341 489
Email: jason.pomaroff@mendelsons.com.au

Mendelsons Lawyers Pty Ltd (ACN 125 099 701) *in association with Prushka Fast Debt Recovery Pty Ltd (ACN* 005 962 854) | *8 Station Street, MITCHAM VIC 3132*