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WHITE PAPER

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New Insolvency Processes for Small Australian Businesses: Quicker, Cheaper, and (Generally) Less Creditor-Friendly

During the better part of 2020, the federal government has injected an unprecedented level of stimulus into the Australian economy in an attempt to mitigate the economic impact of COVID-19. As a result, despite a significant contraction in the Australian economy, roughly half as many Australian companies are entering insolvency processes today compared with the same time last year. As that stimulus is wound back, it seems inevitable that the number of insolvencies will rise.

In an attempt to address the anticipated rise in insolvencies, the federal government has announced a number of reforms intended to assist small businesses to restructure and has released draft legislation for comment.

The focus of the reforms appears to be on ensuring that businesses and jobs survive, potentially at the cost of unsecured creditors and suppliers. The federal government has provided very limited detail regarding the reforms, and the information that has been provided raises many questions and issues, relating both to how the reforms will work and whether they will have the intended effect.

In this *White Paper*, we summarize the proposed reforms, some of the key issues and questions arising, and the likely impact on creditors.

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OVERVIEW OF THE REFORMS

If passed by the Parliament, the reforms will come into effect from 1 January 2021. This likely means that the moratorium on civil liability for insolvent trading for directors, which was introduced earlier this year in response to the COVID-19 pandemic, will not be further extended and will come to an end on 31 December 2020.

Under the proposed reforms, a "small business" is one with liabilities of less than $1 million. In announcing these reforms, the Federal Government has suggested that the reforms will capture around 76% of businesses subject to insolvencies today. Although the reforms have been driven by the pandemic, the majority of them are intended to be permanent measures.

A new reorganisation process is the keystone of the reforms. The Government has, in the material released to date, emphasised its similarities to Chapter 11 of the Bankruptcy Code in the United States. The main similarity is that both are "debtor in possession" processes. However, there are very significant differences—in particular, unlike a Chapter 11 reorganisation, the new reorganisation process is an out-of-court process and generally does not allow for secured claims to be compromised. In reality, the new process is better described as a hybrid of the existing safe harbour for insolvent trading, and a streamlined version of the voluntary administration process which exists under Part 5.3A of the *Corporations Act 2001*.

The reforms will also introduce a simplified liquidation process, some changes to the licensing of liquidators, and potentially some permanent changes to the statutory demand thresholds.

Detail on the new processes and other changes are set out later in this *White Paper*.

WHAT DO THE REFORMS MEAN FOR CREDITORS?

Unsecured Creditors

Based on the information that has been released to date, it appears that the new reorganisation process and simplified liquidation process will have fewer protections for unsecured creditors in order to make the processes quicker and cheaper than the existing alternatives.

In particular:

- Only a majority of creditors by value need approve any reorganisation plan at the end of the new reorganisation process; and
- The extent to which creditors can be treated differently under the reorganisation plan has not yet been announced.

Creditors may not have access to all of the protections available to them under the voluntary administration process (e.g., detail has not been provided of the circumstances, if any, in which a court can set aside a reorganisation plan).

Similarly, the simplified liquidation process will have reduced circumstances in which a liquidator can seek to clawback unfair preference payments from a creditor that is not a related company. The government has not described what these limitations will look like, or what assets will be not be available to creditors under the simplified liquidation process as a result of those limitations.

Secured Creditors

The Court has the power to limit the rights of secured creditors if a company executes a deed of company arrangement after a voluntary administration. It is not clear whether similar powers would exist in relation to any plan executed after the new reorganisation process.

Otherwise, neither the new reorganisation process nor the simplified liquidation process appear to treat secured creditors significantly differently to the existing alternatives, except to the extent that any portion of the secured debt exceeds the realizable value of the security interest. From a practical perspective, that portion is essentially unsecured, and the comments above apply.

Landlords

It is not yet certain how landlords will be treated differently under the new processes compared to the existing alternatives.

In a voluntary administration, the voluntary administrator will be personally liable for rent incurred more than five business days after the administration began, unless they provide notice to the landlord during that period that the company

does not “propose to exercise rights in relation to the property” or the Court makes orders indicating otherwise. The company remains liable for the rent regardless, but the landlord is unlikely to see the rent paid in full unless the administrator is personally liable. Detail has not been provided as to what priority “post-appointment” debts will have, much less how leases in particular will be treated.

The Court also has the power to limit the rights of lessors if a company executes a deed of company arrangement after a voluntary administration. It is not clear whether similar powers would exist in relation to any plan executed after the new reorganisation process.

Under the existing liquidation process, the liquidator has the power to disclaim various contracts, including leases. While it seems likely that power would continue to exist under the simplified liquidation process, no guidance has been provided at this stage.

Suppliers, Equipment Lessors, and Financiers

The extent to which the reforms impact suppliers and financiers will largely depend on the extent to which they have a registered or perfected security interest in relation to the assets of the company—holders of registered or perfected security interests will be secured creditors, and those without will be unsecured creditors.

Similarly, the position of equipment lessors will largely depend on the extent to which they hold “PPS Leases”—i.e., leases that are deemed security interests under the *Personal Property Securities Act 2009* (Cth) and require registration on the Personal Property Securities Register. To the extent that lessors have registered PPS Leases, or leases that do not require registration, the commentary above in relation to landlords applies. To the extent they do not, it is likely that they will be unsecured creditors.

DETAIL ON THE NEW PROCESSES AND OTHER CHANGES

Small Business Reorganisation Process

A new debtor in possession process will be available to businesses with liabilities of less than $1 million. The process is a hybrid of the existing safe harbor for insolvent trading, and a streamlined version of the voluntary administration process which exists under Part 5.3A of the *Corporations Act 2001*.

The most significant difference between the new process and a voluntary administration is that the directors stay in control of the company throughout the process.

The basic steps involved in the new process are outlined below.

Table 1. Overview of Small Business Reorganisation Process		
No.	Step	Timing
1.	Announce intention to access the restructuring process (temporary). Insolvent trading liability is suspended upon the making of this announcement, and is suspended for the duration of the reorganisation process.	Up to 3 months prior to commencement of the process
2.	Board resolves to appoint practitioner as the company's small business restructuring practitioner (SBRP). The SBRP will have proposed, and the board accepted, a flat fee for their work in helping the business to develop a restructuring plan. A moratorium on enforcement action against the company or in relation to personal guarantees, and a protection from ipso facto clauses, commences upon appointment of the SBRP.	Day 1
3.	The directors continue to control the business and trade in the ordinary course. Unlike a voluntary administration, it does not appear that the SBRP will be liable for expenses incurred during this period. Meanwhile, the board works alongside the SBRP to develop a restructuring plan over 20 business days. The plan includes the SBRP's remuneration, which will be a percentage of disbursements made under the plan.	Day 1 to business day 20
4.	SBRP sends the plan and supporting documents to creditors and certifies whether they consider the business: Can meet the proposed repayments; and Has properly disclosed its affairs. The company must lodge any outstanding tax returns and pay any employee entitlements that are due and payable *before* the plan is put to creditors.	20 business days after Day 1
5.	Creditors vote on the proposed plan and SBRP remuneration. Creditors vote as one class. Related-party creditors are not entitled to vote, but it is not yet clear exactly which creditors will be "related-party creditors" for the purposes of the new reorganisation process.	20 to 35 business days after Day 1
6.	If a majority of creditors voting by value vote to approve the plan, the plan is then binding on: All unsecured creditors; and Secured creditors to the extent that any portion of their debt exceeds the realisable value of the security interest. There is *no* requirement for a majority of creditors by number to have voted in favor of the plan (unlike in a voluntary administration). If the plan is not approved, the directors may opt to place the company into voluntary administration or liquidation (including the simplified liquidation process set out below).	35 business days after Day 1
7.	If the plan is approved, the SBRP administers the plan and makes distributions to creditors in accordance with the plan. The business continues to be run by the directors.	More than 35 business days after Day 1

The government has noted that safeguards will be included in the small business reorganisation process to prevent it from being used to facilitate corporate misconduct such as illegal phoenix activity. This includes a prohibition on related creditors voting on a restructuring plan, a bar on the same company or directors using the process more than once within seven years, and providing SBRPs the power to stop the process where misconduct is identified.

Simplified Liquidation Process

The government is yet to release significant detail in relation to the proposed simplified liquidation process. It has, however, confirmed that it will retain the general framework of the existing process, with time and cost savings achieved through reduced investigative and reporting requirements, and removing requirements to call creditors meetings or form committees of inspection.

In particular, key modifications will include:

- Reduced circumstances in which a liquidator can seek to clawback unfair preference payments from a creditor that is not related to the company.
- Only requiring the liquidator to report to ASIC on potential misconduct where there is reasonable grounds to believe that misconduct has occurred.
- A simplified dividend process (where creditors receive a proportion of their debt) and proof of debt process (where creditors prove to the liquidator the debts they are owed).
- Allowing the use of technology in creditors' voting and other communications.

The government has indicated that the rights of secured creditors and the statutory rules regarding the priority of creditors (such as employees) will not be modified by the proposed simplified liquidation process.

As with the new reorganisation process, the simplified liquidation process will only be available to companies with liabilities of less than $1 million.

Changes to Insolvency Practitioner Licensing

A number of permanent and temporary measures intended to expand the availability of insolvency practitioners have been announced alongside the reforms.

Table 2. Insolvency Practitioner Licensing

Temporary Measures	Permanent Measures
Waiving fees for registration as a registered liquidator until 30 June 2022	Removing requirements which are "overly rigid, but do not provide demonstrated benefit in ensuring the integrity of the profession" Making processes required by the *Corporations Act 2001* more "technology neutral" A new classification of liquidator whose practice will be limited to the new simplified restructuring process only

As with the simplified liquidation process, there is significant missing detail in what has been announced to date—in particular, there has been no guidance as to what the government considers to be "overly rigid" requirements, nor has there been guidance on what licensing requirements the new class of liquidators would not be required to meet.

Permanent Changes to the Statutory Demand Thresholds

The government has also noted that a consultation process will be undertaken on the appropriateness of permanently raising the minimum threshold at which creditors can issue a statutory demand to a company.

The $2,000 threshold was temporarily increased to $20,000 in response to the COVID-19 pandemic, but is currently scheduled to return to $2,000 in December 2020. The $2,000 threshold can be traced back to recommendations made in an Australian Law Reform Commission report from 1988 (commonly referred to as the "Harmer Report"), which in turn relied

on then-recent court decisions suggesting that a claim under that amount was "beneath the dignity of the court".

In contrast, the threshold for issuing a bankruptcy notice to an individual was raised from $2,000 to $5,000 in 2010 (though a senate committee at the time recommended that it be increased to $10,000). This was also temporarily increased to $20,000 in response to the COVID-19 pandemic.

QUESTIONS YET TO BE ANSWERED

The detail which the government has released to date is limited, which means that there are a number of issues raised in the proposed reforms that are currently unanswered. We set out below some of the key questions and issues arising from the material released to date.

How Will the Company's Liabilities be Calculated?

The new reorganisation process and simplified liquidation process will only be available to companies with liabilities of less than $1 million. However, the government has not yet released any detail on how those liabilities will be calculated, particularly in relation to the treatment of:

- Contingent liabilities, such as under leases of premises, vehicle, plant and equipment;
- Liabilities incurred by companies as trustee of a trust; and
- Liabilities of subsidiaries and other companies in the group (if any).

Will Creditors or Counterparties be Notified?

Will the company or its directors be obliged to notify creditors and counterparties that the company is in the reorganisation process, or is intending to enter it? If not, what awareness will creditors have of the company being in the new reorganisation process, particularly while the temporary protection arising from a notification of an intention to enter the reorganisation process is in place?

Any creditors that deal with a company in voluntary administration must be put on notice of that fact, but in contrast, a company generally need not advise its creditors that it is operating within the safe harbor for insolvent trading.

What Priority will "Post-Appointment" Debts Have?

What protections will be given to new and ongoing creditors if they continue to provide goods, services, or credit throughout that process—particularly if the reorganisation plan is not approved and the company enters liquidation?

In a voluntary administration, the administrator would be personally liable for those amounts, and those creditors would almost always receive 100c in the dollar for those amounts.

Can Personal Guarantees from Directors be Compromised?

Creditors are prohibited from enforcing personal guarantees given by directors or their relatives during the reorganisation process, but what occurs in relation to those after the process has completed? In a voluntary administration, claims against third parties cannot be compromised in a deed of company arrangement.

This will be particularly relevant for small businesses, where key creditors are likely to have relied on personal guarantees from directors, possibly secured against a mortgage over the family home.

What are the Minimum Requirements for the Plan?

No detail has been provided in relation to whether the reorganisation plan must contain certain basic requirements to be valid. Similarly, the Government has not said whether there will be a limit on how long a plan can operate—i.e., will there be a maximum period in which creditors must be paid?

What Protections will Exist for Creditors?

In a voluntary administration, a deed-of-company arrangement must be approved by a majority of creditors in both number and value, preventing a handful of creditors from controlling the entire process. Creditors may also apply to have a deed-of-company arrangement set aside, giving them some protection from oppression by the majority. The proposed reforms only require a majority by value, and it is unclear which of the other protections that exist in a voluntary administration will also apply in the new process. This is particularly relevant in the insolvencies of small companies, where the ATO is often the largest creditor by some margin.

Similarly, the extent to which creditors can be treated differently under the reorganisation plan has not yet been outlined

by the government. What protections will exist to prevent directors from structuring the plan in a way so as to "buy" the votes of the creditors owed the most, at the expense of all other creditors?

What if the Plan Fails?

What occurs if a reorganisation plan fails, if that is possible, and how would "failure" be determined? Would the company automatically be placed into an external administration process, or would control remain with the directors to determine whether or not that is appropriate?

How will the Integrity of the Insolvency Practitioner Profession be Maintained?

As noted above, there is currently little guidance on what the new liquidator licensing regime will look like, and who will fill the role of the new class of liquidators—it will need to carefully balance the desire to increase the number of insolvency practitioners, while protecting creditors from less scrupulous operators.

Will Practitioners be Willing to Act as SBRPs?

The main avenue of remuneration for the SBRP is a percentage of the distributions paid to creditors. In many instances, it is likely that any distribution will be quite small and paid over a period of time, possibly many months or longer. Will this discourage insolvency professionals from seeking these appointments?

Will the Simplified Liquidation Process Reduce the Return to Creditors?

The simplified liquidation process will have reduced circumstances in which a liquidator can seek to clawback unfair preference payments from a creditor that is not a related company. It is not currently certain what these limitations will look like, or what assets will be not be available to creditors under the simplified liquidation process as a result of those limitations.

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