Australian Government

Australian Small Business and Family Enterprise Ombudsman

Mr Daniel McAuliffe
The Manager
Corporations and Schemes Unit
Financial Systems Division
The Treasury
Langton Crescent
PARKES ACT 2600

25 May 2016

Dear Mr McAuliffe

**IMPROVING BANKRUPTCY AND INSOLVENCY LAWS**

Thank you for the opportunity to comment on Treasury's Proposals Paper on the above topic. As you may be aware, the Australian Small Business and Family Enterprise Ombudsman (the Ombudsman) has a range of legislative powers, including the power to review proposals to determine the effect on small business and family enterprise, and how proposals might be improved.

## General comments

We strongly support improving legal frameworks to better foster innovation and entrepreneurialism among the small business and family enterprise community. This is of value to individual small businesses and family enterprises but also the nation as a whole given their importance to Australia's economy. Accordingly, we commend the focus of this reform package.

Small businesses operate through a variety of structures, such as companies, partnerships, trusts and as sole traders. It is also common for a small business failure to be caught up in both the insolvency and bankruptcy regimes, for example where directors have personally guaranteed debts where a company is unable to pay. Accordingly, to ensure flexibility in choice of structure and simplify matters, it is beneficial to have the rules applying to small business (regardless of entity type) as consistently in terms of impact as possible.

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Whatever approach is ultimately adopted, we also believe that it is advisable to ensure that a post implementation review is conducted to ensure that the approach is effective and does not have unintended consequences.

Against this general background, we offer the following high level comments:

**Proposal one: Reducing the current default bankruptcy period**

We support the policy intent of this proposal, namely to encourage innovation, entrepreneurial activity and business start-ups. We agree that this is important to improve productivity and foster a business culture that encourages necessary risk-taking by the individuals behind Australia's small businesses and family enterprises. We also recognise that many entrepreneurs will fail before they ultimately achieve success, and that penalising and stigmatising entrepreneurs is counterproductive.

We consider that for unincorporated small businesses, policies that reduce the stigma and consequences associated with failure should be balanced by policies that promote success (such as Proposal two). We encourage the Government to promote the use of services such as those funded through the Australian Small Business Advisory Services Program as part of its approach when implementing these reforms.

**Proposal two: Introducing a safe harbour for directors for insolvent trading**

We strongly support the policy intent of this proposal, being to offer a cost effective and flexible mechanism for businesses to work through liquidity issues outside of formal administration. We agree that there are inappropriate barriers placed in the way of businesses trading out of difficulties.

For directors of incorporated small or family businesses who find themselves with cash flow or other financial difficulties, there are significant advantages in the introduction of a safe harbour from director personal liability for insolvent trading. The proposal supports these businesses by allowing them to get the help needed to turn a viable business around. In this regard, it would appear beneficial for Model B to be even more closely linked with the appointment of a restructuring adviser than outlined in the Proposals Paper (at page 16):

> "The requirement that directors take 'reasonable steps to maintain or return a company to solvency within a reasonable period of time' would be considered by the court in circumstances where the defence is raised, and the formal appointment of an appropriately qualified and experienced restructuring adviser would be included in that consideration."

For small businesses and family enterprises that are creditors of a business in financial difficulty, the reforms are also beneficial if the outcome is that a debtor

business is able to effectively trade through a period of financial difficulty instead of prematurely entering administration.

The former Office of the Australian Small Business Commissioner (the ASBC) produced a report into the impact on a number of small businesses following the collapse of a major subcontractor involved in building the new Ben Chifley Building in Canberra. The set of circumstances provides an excellent case study in the impact of bankruptcy and insolvency on small businesses and is highly relevant to the Proposals Paper. In that case, the collapse of a local business in Canberra left 180 subcontractors unpaid. However, had there been scope for the business to trade through its liquidity issues, this would have likely produced a better outcome for the 180 small businesses who were impacted. We **enclose** for consideration a copy of the ASBC's report and note that this case study is discussed further below.

***Model A preferred***

Of the two mechanisms proposed for implementing this reform, we prefer Model A. We consider it important that an independent perspective and expertise is sought in the context of a company experiencing financial distress. In particular, the restructuring adviser's expertise in running a business effectively is critical.

In addition to the safeguards outlined in the Proposals Paper, we consider the following are important:

1. Prompt opinion as to viability

   Setting a timeframe within which the restructuring adviser must form an opinion about whether a company is viable. We consider that this should be a relatively short period of time – eg. 30 days. Because companies will not automatically be required to disclose to creditors and other businesses that a restructuring adviser has been appointed, it would be unacceptable if a company was allowed to trade for an extended time if the ultimate opinion of the restructuring adviser is that a company is not viable.

2. Timeframe for solvency

   Setting a timeframe within which the company must be returned to solvency or otherwise have an administrator appointed – eg. 6 months. There may be provision to extend this period where cause is shown.

3. Suitability of advisers

   In implementing this Model, it is important to properly match advisers with businesses and ensure that advisers have adequate skills (beyond law and accounting) that are suited to turning around a business. We agree that the

onus should be on the company directors to ensure that the experience and qualifications of a restructuring adviser are appropriate for the nature and circumstances of a company. However, it is important that guidance is clear in this regard and assistance provided (where appropriate) to ensure that there is a good match between small businesses and their advisers.

**Proposal three: *Ipso facto* clauses unenforceable where insolvency event**

Subject to the observations below, we support the general intention of this proposal, being to allow companies to trade through difficult periods where, all other things being equal, an *ipso facto* clause could make the difference between survival and failure. This makes particular sense where an insolvency event is accompanied by a company "undertaking a restructure".

In support, we draw your attention to a similar problem that exists in relation to procurement panels across government. As noted above, the ASBC produced a report into the impact on a number of small businesses following the collapse of a major subcontractor involved in building the new Ben Chifley Building in Canberra. Among other things, the report recommended that:

> *'Governments across jurisdictions consider exceptional circumstances prior to removing businesses in external administration from procurement panels.'*

This recommendation followed a finding that, were it able to access work from the ACT Government, the subcontractor may have been able to trade through its losses and pay the large number of smaller businesses that did not receive payment as a result of the voluntary administration and eventual liquidation of the subcontractor. In effect, this is the same issue that Proposal three relating to *ipso facto* clauses is seeking to remedy.

The 'safety net' built into Proposal three allows a contractual party to apply directly to a court to vary the terms of a contract "if they can show they have suffered hardship". Following our consultation with small business representatives, there is a concern that because this test requires hardship to have been suffered, businesses are forced to endure hardship in order to approach a court even where that hardship is foreseeable. Placing small business under this sort of strain where it is avoidable is inappropriate. It is our view that the safety net should be broadened to allow businesses to apply to the court to vary the terms of a contract where there is a *reasonable likelihood* of hardship (ie. 'prospective hardship').

We make the further observation that invoking a court process is a significant and costly step for a small business. The potential for hardship may be significant for a small business even where the value of a contract makes invoking court procedures

an unrealistic option. Therefore, we believe that there is value in reversing the presumption where a small business wishes to rely on an *ipso facto* clause. That is, rather than making void *ipso facto* clauses subject to the power of a court to vary for hardship, where a small business wishes to rely on an *ipso* facto clause the clause should be valid (potentially subject to a power of a court to prevent reliance on such a clause in appropriate circumstances).

We hope that these comments assist you and we would be happy to discuss these matters with you further. Please feel free to contact either me or my Deputy, Dr Craig Latham, by telephone (02 6263 1506) or email (craig.latham@asbfeo.gov.au).

Yours sincerely,

Kate Carnell AO
Australian Small Business and Family Enterprise Ombudsman