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Our reference
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AUG/1221322698.2

12 October 2020

By Email

Dear Sir / Madam

CORPORATIONS ACT PART 5.3B - SUBMISSIONS ON EXPOSURE DRAFT

We set out below submissions on the Exposure Draft released for the proposed new Part 5.3B of the *Corporations Act 2001* (Cth) (**CA**), which is to introduce a "small business restructuring process" (**Process**) that includes the appointment of a small business restructuring practitioner (**Practitioner**).

Given the urgency of this process of reform, we have kept these submissions high-level, and focused only on what we consider to be key points.

These submissions are provided from the point of view of insolvency lawyers, who advise creditors, debtor companies, appointed insolvency practitioners and other stakeholders in relation to distressed and insolvent companies.

Eligibility criteria - quantum of liabilities of $1M

We note that it is proposed that the Process be limited to businesses with liabilities of **$1M** or less (**Liability Cap**).

Our submission is that the Liability Cap should be lifted, to make the process available to a broader range of businesses.

When one considers unpaid rent (both arrears, and potentially some future rent), ATO debt, employee entitlements, and bank or other lending, only the smallest of businesses seem likely to be eligible for the Process.

Our experience is that restructuring of this nature is necessarily a fairly involved process. Most very small businesses simply do not engage with legal restructuring processes, rather they proceed to restructure by agreement / negotiation. To this extent, the smallest of businesses may not use the process even if it is available to them.

We think it is more likely that businesses in the "liability range" of **$5M - $20M** may benefit the most from the Process, yet also be most likely actually to engage with the Process to restructure. This is because their liabilities are of the quantum and complexity

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that they cannot easily be negotiated or refinanced. This is the space where we consider the Process may be both most needed, and most likely utilised.

Entry into the Process – "insolvency or likely insolvency"

We note that in order to enter the Process the debtor company must be insolvent, or likely to become insolvent (section 453B(1)(b)). This is similar to the existing voluntary administration process. This is reinforced by the fact that proposing a restructuring plan would create a presumption of insolvency for various purposes (section 455A(2)).

Once a company has become insolvent it is often too late to meaningfully assist it.

By contrast, we note that under the recently passed (June 2020) *Corporate Governance and Insolvency Act 2020* (UK) (**CIGA**), and the new Part 26A of the *Companies Act 2006* (UK) which provides for a modified scheme of arrangement (**Part 26A**), the United Kingdom has provided for a comprehensive restructuring regime that is open to businesses of all sizes, and at least so far as Part 26A is concerned, becomes available to businesses while they are experiencing distress but importantly *before* they become insolvent. The test of entry under Part 26A is "[the] *company has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern*".

We attach a comparison we have prepared of the Process, against CIGA and Part 26A, in powerpoint format, in case this is helpful to provide an outline of CIGA and Part 26A, and this point.

Our submission is that an entry point before the onset of insolvency may be helpful to catch problems before they become difficult to solve, and result in more successful restructuring outcomes.

Compromise of unsecured creditors only – multiple sets of restructuring discussions

We note that under the Process:

- secured creditors would maintain their existing rights, in a similar fashion to the existing voluntary administration regime, being that they could separately enforce their security, and need not participate in the restructuring plan under the Process. This would appear to cover all secured creditors, including bank and other lenders holding security, and suppliers holding purchase money security interests (**PMSIs**) or similar;

- employees must be paid out before a restructuring plan under the Process is voted upon;

- unsecured creditors only can be compromised under a restructuring plan under the Process. While amounts owing to landlords may be able to be compromised as unsecured debt, that would almost certainly result in some default and therefore forfeiture under lease agreements, resulting in a loss of business premises unless an agreement can be reached with landlords.

Accordingly, to meaningfully restructure using the Process, a small business would appear to need to conduct multiple and separate restructuring discussions with each of these creditor groups, outside of and in addition to the restructuring plan, because a restructuring plan under the Process can only deal with unsecured creditors.

We consider that a model closer to US Chapter 11 on which the Process is based, may be worth consideration. That is, one legal process that can conduct a comprehensive financial restructuring with all affected creditors and stakeholders "under one roof".

Also, the need to pay out employee creditors before any restructuring plan is voted upon, would seem to create the need for a cash reserve (which may not exist), or a separate restructuring discussion with numerous employees.

Chapter 11 incorporates legal protections for secured and other similar creditors such as "adequate protection" so that secured creditors could receive cash payments to the value of their collateral, or the sale proceeds of their collateral (at the end of the day, the collateral is worth what it is worth), which keeps control with the debtor company and its directors, yet provides flexibility and protection for secured creditors, in a restructuring plan that deals with all creditors.

The Practitioner

We consider that a process that is closer to US Chapter 11, which places more emphasis on the debtor company under restructuring and its directors, may be worth consideration.

We note that various duties or quasi duties to creditors have been placed upon the Practitioner. These include the following duties:

- a declaration to creditors in relation to the proposed restructuring plan (section 453E(1)(c));
- termination of the restructuring process if it is no longer in the interests of creditors to pursue (section 453J(1)(a)(ii)-(iv));
- monitoring that the debtor company is only incurring debts in the ordinary course of business (otherwise the Practitioner's consent is required), and to give any such consent (section 453L(2) and (5)); and
- to provide or withhold consent when approached by creditors seeking to enforce their rights against the debtor company (section 453Q(2)).

We note that under US Chapter 11, the debtor company and its directors owe fiduciary or similar duties to creditors, to act in the interests of creditors when preparing a restructuring plan. In our submission, this is sufficient protection for creditors, and would posit the Process more fully into a debtor-in-possession model.

At the moment, the responsibilities for the restructuring plan are divided up between the company/directors, and the Practitioner. The Practitioner carries various duties to creditors as outlined above, most of which are in essence duties of the directors. Without any indemnity from or lien over the assets of the debtor company, and with limited caps or exclusions from liability such as claims from creditors or other stakeholders (see below), the Practitioner may find that in practice they are not willing to engage with the difficult issues or difficult stakeholders as may be required to meaningfully restructure the business.

Accordingly, our submission is that these duties or roles be shifted to the directors of the debtor company. It may also be worth considering limiting the liability of directors to encourage them to engage in restructuring more courageously, as to which please see our comments below.

The Practitioner and the Directors

One key difference between the US Chapter 11 process, and the Process, is that most major decisions or steps in US Chapter 11 are approved by the Bankruptcy Court. This court blessing takes risk away

from the directors of the debtor company. In practice, in Australia, many trustees and insolvency practitioners proactively seek court directions or approval for major steps or decisions, for this reason.

That said, the constant court applications in US Chapter 11 make the process long and costly.

Against this, the Process appears to be an out-of-court procedure, similar to the existing voluntary administration procedure. Major decisions that fall for the directors of the debtor company, and the Practitioner, would not carry court imprimatur under the Process. Nor would the directors or the Practitioner have any indemnity from or lien over the debtor company's assets to protect themselves from financial liabilities such as claims from stakeholders. Their best professional protection is likely to be in insurance, and making good sensible decisions.

Stakeholders that have lost money can become unreasonable. It may be worth considering including some protection mechanisms for both the directors of the debtor company, and the Practitioner.

Further, the Practitioner also owes duties to the debtor company and so to its directors, for example to provide it with advice on matters relating to restructuring, and to assist it with preparing a restructuring plan (sections 453E(1)(a) and (b)). In light of the various duties that the Practitioner also owes to creditors of the debtor company (outlined above), this may at times place the Practitioner in tricky situations of conflict.

We consider that one option to consider here may be some form of limitation of liability. Something approaching such a limitation of liability appears in section 456H, which provides that no action for damages lies against the Practitioner for decisions in relation to termination of the restructuring, or decisions to give or withhold consent (for example to enforcement action by creditors). However, this limitation could be wider, and cover more of the duties owed by the Practitioner, outlined above.

Some mechanism may also be worth considering to limit the liability of directors in connection with the restructuring plan, to give them the courage to propose a meaningful plan that actually addresses their issues, noting that there would be no court imprimatur for key decisions as seen in US Chapter 11. We interpret the Process to be one where directors' duties continue to apply, which would mean directors owe at least some duties to creditors. We think there is potential here for limitations of liability if the directors act in good faith, or some form of business judgment rule, to limit the burden on directors. This lies against the background that the existing illegal phoenixing provisions of the CA would continue to apply to the directors, which provisions would provide significant protections to creditors and other stakeholders.

Please contact Lionel Meehan on lionel.meehan@dlapiper.com with any queries on these submissions.

Yours sincerely

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