CORPORATIONS AMENDMENT (CORPORATE INSOLVENCY REFORMS) BILL 2020

Submission by:

Allan Eskdale

eskdalea@bigpond.com

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Executive Summary

Introduction

My name is Allan Eskdale and I have had lengthy experience in advising and working with SME businesses which were, or were about to become, insolvent.

I have been working with small and SME businesses for most of my working life and specifically, since 1995, trying to find a way to encourage SME directors to act earlier. If directors did act when they became insolvent (i.e. two years before they run out of cash) many businesses would have good prospects for successful turnaround or restructure.

In my experience little is known or understood about the failure of SME businesses. There is little interest from professional bodies and associations as they are not a profitable sector.

The threat of being liable for trading insolvently has been no deterrent to insolvent trading. Any thought that some different regime will change this behaviour is fanciful. Ego, fear and the reluctance to pay fees for professional advice will always ensure that businesses will take no action.

Micro, small and SME businesses, however they might be defined, are an important part of the Australian economy. They are important components of the supply chain and distribution channels of larger businesses and are a significant employer. An efficient, productive, and innovative sector will provide massive impetus to the nation's recovery from the Coronavirus. Initiatives that restore the pre-Coronavirus status quo of a significant insolvent and unproductive SME sector must be avoided.

I am responding to the draft legislation and explanatory materials for the same reason as I responded to the Banking Royal Commission. Without an understanding of the true foundation underlying causes, proposed solutions to the visible problems will not achieve the desired outcomes, and future analysis and review will not be able to identify why they were not achieved.

Key issues

SME businesses fail because they are undercapitalised and poorly managed.

The VA regime has not failed. While an administrator is supposed to be appointed when a business is insolvent, this typically happens when the business runs out of cash and is unable to pay suppliers or wages. This might be between one to two years after becoming insolvent.

One of the practical outcomes of a business trading until cash and liquid assets are exhausted is that there is diminished opportunity to 'trade on' or sell the business as a going concern. There will be insufficient funds to provide for a proper administration or material (if any) distribution to creditors. Creditors will then resort to any means to try and increase their priority or make a claim against directors or the Administrator.

The administrator is required to compete hard to protect assets for creditors (not to mention, their fees). This has become a costly legal fest and I recently likened it to a pack of wild dogs fighting over a chicken leg.

While the coronavirus is a 'black swan' event of sorts, the effects are exaggerated by the number of insolvent businesses that were still trading at March 2020, mostly already on ATO payment plans. Prior to the GFC directors might have been forced to take action by banks or the ATO but pressure from media, the government, small business ombudsman, and others combined with self-interest has resulted in increasing leniency allowing businesses to trade until they run out of cash.

Proposed Insolvency Reform

I am not a lawyer, or an expert on insolvency legislation. Like "Safe Harbour" I see this legislation as being a pragmatic response to a perceived problem. While the Safe Harbour EM correctly identified that "Hope is not a strategy", the facts are that it is the strategy favoured by most small business owners and their creditors (including the banks and ATO).

My understanding of Chapter 11 is limited, but generally it seems to me that a court driven process lacking transparency is not the right solution in Australia, where business act only when they run out

of cash.

I prefer to view the proposed regime as a hybrid of a streamlined DOCA / scheme of arrangement without the court timetables which currently render schemes as being an unsuitable strategy for restructure or turnaround.

Businesses that are restructured, or revert to the owners, under a DOCA usually fail because there is no new capital and the same poorly performing managers continue to run the business. This is a significant risk with the proposed restructuring as debt will effectively be cancelled but owners will then continue trading in the same manner without a capital injection or the hiring of new management expertise.

They will end up insolvent again, although maybe the government merely wishes to 'flatten the curve' of insolvencies and FEG liabilities.

Recommendations - Insolvency Reform

While I can see the need for legislating by extending the current regime and then detailing regulatin later as more information comes to hand. There are risks in legislating by regulation, most particularly continuing uncertainty in an area of business that desperately needs certainty. A period of twelve months could be sufficient to "clear" a backlog, by which time a better system to delineate corporations by size and risk might be considered.

There are some potential risks:

1. There is likely a shortage of insolvency professionals to meet demand. This legislation probably does not alleviate the problem as restructuring professionals will still need to be drawn from the insolvency industry. The structure of the legislation does not lend itself to drawing new professionals into the sector.
2. Many SME insolvencies start with a significant under-estimation of liabilities due to financial management and record keeping which could force companies out of the simplified systems into mainstream insolvency.
3. A lack of information about how this sector really operates. There is a risk that consultation is being held with organisations that have little knowledge of the pitfalls of insolvent administrations of SMEs. I would strongly recommend that regulations be formulated in conjunction with legal and insolvency practitioners who have a proven track record of working in this sector. Please avoid letting the blind lead the blind.
4. Where a "restructure" fails the funds available for a subsequent liquidation are reduced by continuing unprofitable trading as well as the legal and professional fees incurred.
5. The liability for FEG should only have been borne by the government for an initial transition period, refer to "Employee Entitlements" below. Businesses benefiting from these restructuring provisions should be immediately required to commence transition to fully funding leave entitlements.

Recommendations - Commercial Problems Require Commercial Solutions

Government intervention into the commercial world is usually problematic. Stimulus cash usually goes into the pockets of a narrow sector skilled at positioning itself to benefit. Risks always manage to find their way back to the government balance sheet. There is a "grant mentality" in government which favours solutions that involve announcements, payment and minimal responsibility for administration or the monitoring of outcomes.

I would recommend that consideration be given to the following initiatives:

1. The liability for FEG should only have been borne by the government for an initial transition period. I discuss the way a transition could be phased in over a period of time in the section "Employee Entitlements" below. Businesses receiving financial benefits from any future government initiative should be immediately required to commence transition to fully funding leave entitlements.
2. There is merit in legislating that small entities should have a light touch means of dealing with

insolvency. However, it is also a case of acting after the horse has bolted. It is unfair on creditors and employees who may have been relying on greater protection. There is a case for a corporate regulation to be dependant on size and relative risk to others. Refer “License to Trade” below.

3. Government initiatives to stimulate growth and resilience in the SME sector need to focus on the generation of new capital and increasing management expertise. The proposed Business Development Fund does not provide sufficient accountability and security over the return of funds.
4. The banks, ATO and the Government (re FEG) have the most funds at risk in any insolvency. Without new capital and improved management, a large proportion of these funds will be lost. Whilst the ATO will benefit from any business recovery, it is the banks and FEG that would most benefit from providing funds to minimise the risk of future losses. Structures which would allow FEG to be advanced in a manner that can enhance the recovery prospects while minimising the risk of government losses must be investigated.
5. The government cannot afford a sudden fall in property values as it could result in a circle of forced sales and further losses. Equally it is unaffordable to let prices relentlessly rise, forcing home buyers out of the market and the cost of living to a point where wages cannot be internationally competitive. Again, commercial solutions need to focus on the parties with the risks; owners and financiers.

Limitations of Consultation

Professional, business, trade and labour associations are no longer necessarily a sound source of information as they have evolved themselves into large businesses, often administered by professional administrators. Administrators may not have a deep knowledge of the association’s industry and the role of the members executive may depend on a wide range of circumstances.

Mostly they will cater to the interests of the bigger end of town as nobody profits from dealing with poorly managed and failing SME businesses.

While the Small Business Ombudsman is specifically tasked to deal with small business, their lack of expertise and resources means that they seem to be a megaphone for complaints. I rarely encounter a small business owner who takes responsibility for their own deficiencies. It is always the bank, tax office, customer or supplier who is the cause of their failure.

Employee Entitlements

In late 2001 I wrote to the Institute of Chartered Accountants suggesting that they lobby for change to the GEERS system, as it then was. I do not have a back up of my emails at the time and the attached file may or may not be the final draft.

I do recall at the time that my final email, or subsequent discussions with the ICA also included a suggested process of transition to the funding of entitlements by businesses:

- A separate bank account to be opened and balanced monthly (or quarterly) to the liability
- Annual audit of leave entitlements in conjunction with the Workers Comp audit
- Phase in over 5 years

The ICA’s view was that these provisions were an important self-funding mechanism for small businesses and were quite dismissive of my understanding of this simple business issue. I did not, and still do not, subscribe to this view. Any sound business should be generating cash profits after allowing for entitlements or have raised sufficient capital to cover its cash losses after setting aside cash for entitlements.

If businesses are not profitable or insufficiently capitalised to do so, then they should not be in business. Better they go broke straight away than years later with many creditors and unfunded employee entitlements.

License to Trade

As it stands anyone can open a business and proceed to run up liabilities which will never be repaid.

On the road this is only possible if I am a cyclist and unlikely to cause significant damage to others. If I wish to drive more dangerous vehicles, then I must demonstrate that I have the skills to do so.

There has been endless discussion over director regulation and education, and it is time for more black and white prescriptive legislation.

This could be as simple as something like the following:

1. Turnover < $1m and employee/contractor hours per week < X hours
2. Turnover < $10 m
3. Turnover < $30m
4. Turnover > $30m

Where:

1. There is light touch regulation and insolvency, typically sole traders, partnerships and micro companies with sole directors
2. Accounts of these companies would require review by tax agent that there is reasonable controls over balance sheet and P&L (but not an audit) and key financial data is included in the annual return
3. Limited audit and special purpose accounts not requiring full application of accounting standards and financial data included in Annual Return
4. Subject to audit with financial data included in annual return

The major problem is the application of overly detailed and overly numerous financial standards, but something needs to be done about the lack of governance and compliance in these companies.

It will be largely at the discretion of owners whether they comply. However, in the case of insolvency, the failure to do so should result in a prime facie assumption that the company has traded insolvently and that directors should be personally liable for outstanding debts.

This runs counter to the prevailing view that we need to make requirements less onerous for directors. My view is that we need simple rules to reduce the incidence of failing companies running up huge liabilities without accountability.