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The Manager
Market Conduct Division
Treasury
Langton Crescent
PARKES ACT 2600

By email: MCDInsolvency@Treasury.gov.au

Dear Sir/Madam

Insolvency Reforms to Support Small Business

Submission

Background

I am the partner in charge of the insolvency division of Pitcher Partners – Melbourne (PPM). I am a registered liquidator and registered bankruptcy trustee. PPM has three (3) registered liquidators. We have significant experience in investigating and pursuing phoenix activity and fraud and of investigating corporate wrongdoing.

We wish to make a submission on the proposed Insolvency Reforms to Support Small Business (reforms)

Executive Summary

The following is a summary of our primary position concerning the reforms:

Restructuring Scheme

- We support the debtor in possession model.
- We support the requirement that a Small Business Restructuring Practitioner (SBRP) be a registered liquidator.
- The regulations must require the SBRP to:
    - Make a recommendation to creditors whether the company's proposal is in the best interests of creditors, or whether the company should be wound up.
    - Make a comparison (based on information obtained during the 20-business day period) between the outcome for creditors were the proposal accepted and the outcome for creditors were the company wound up.
- To minimise the risk that parties associated with the company manipulate voting outcomes, the value attributed to the vote of an assignee of a debt should be restricted to the amount actually paid for the assignment.
- To preserve the SBRP's independence, the regulations should allow flexibility in level of remuneration and the timing and manner of its payment.
- The restructuring process is intended to apply to small businesses. The eligibility criteria should ensure that companies part of a larger solvent group of companies are not unintentionally allowed to use the restructuring process.

- To protect the integrity of the restructuring process, an SBRP must have the ability to require appropriate evidence of and adjudicate creditor claims.
- A company should only be eligible to access the restructuring scheme if its tax lodgements are up to date.
- A company should be ineligible to access the restructuring scheme if a current director (or a person who has been a director of the company within the previous 2 years) has been a director of a company which has used the restructuring scheme.
- The regulations must require a company's proposal to include an essential term that any outstanding employee entitlements will be paid in full across the life of the proposal.

Simplified Liquidation

- The proposal restricting a liquidator's ability to recover unrelated party preferences should not be adopted.

General

- All insolvency practitioners should be given free access to ASIC registers.
- Where an entity under external administration is or was (within 2 years) a trustee of a trust, the insolvency practitioners should be automatically appointed as receiver of that trust. Aggrieved parties should be able to apply to challenge the default appointment.
- To support the integrity of the insolvency regime, ASIC should charge an additional fee on incorporation, or in addition to the annual fee to fund improved investigation and prosecution of corporate misfeasance and wrongdoing.
- We believe that there is scope for the reforms to be abused by rogue operators and for the scheme to lead to significant unintended consequences. Consequently, we recommend that the reforms have a 2-year hard sunset operation which will require the Federal Government to monitor, review and reconsider the operations of the provisions within 24 months.

Detailed Submissions

We make the following detailed submissions on the reforms.

Content of Regulations – Recommendation & Comparison

The reforms contemplate that the SBRP will be responsible for helping to formulate and then communicate the company's proposal to creditors within 20 business days. This timeframe is not dissimilar to the time in which a Controlling Trustee must communicate with creditors under Part X of the Bankruptcy Act 1966 (BA).

We recommend that the Regulations stipulate that the report to creditors by the SBRP include a requirement for the SBRP to provide a recommendation to creditors as to whether the proposal is in the best of creditors. Creditors must have appropriate information on which to make an informed decision about the proposal. Creditors will be almost exclusively reliant on the SBRP in this regard. The information should include:

- The view of the SBRP as to whether the proposal should be accepted or rejected.
- The SBRP's opinion on whether the company has sufficient financial capacity to perform the obligations set out in the proposal.
- The SBRP's best estimate of the likely outcome for creditors were the proposal to be rejected and the company were wound up.
- A summary of the SBRP's enquiries into specific issues including antecedent transactions or matters that should be investigated.
- The SBRP's view of the state of the company's records.

This reporting and comparison obligation is appropriate and ought not be onerous:

- The content and detail of the report will reflect the inherent limitations of a 20-business day period.
- Without a comparison to a notional liquidation, there is no reference point from which creditors can assess whether to accept or reject the proposal. It would materially affect a creditor's decision to learn that the company engaged in antecedent transactions including transfers of significant assets to the director for no consideration in the years prior to the proposal. This will compel the SBRP to make reasonable enquiries during the 20-business day period.

- Given the limitation of 20 business days, the SBRP will not have time to conduct detailed investigations. The SBRP should state what enquiries were made and what information was and was not obtained.
- The SBRP's report should acknowledge any limitations in the enquiries undertaken and information procured. This process is similar to the Controlling Trustee's Report to Creditors under Part X of the BA. Creditors can then weigh those limitations in their decision making on the proposal.
- The obligation to comment on the state of company records is essential. From our experience, a major factor in a company's failure is the lack of adequate records as directors have no ability to regularly review the financial position and performance of the company and make any key and informed decisions. It would materially affect the future prospects of a plan and a creditor's decision to learn that the company had limited records explaining its financial affairs for the years prior to the proposal.

Remuneration – Level and Flexibility

The reforms contemplate that the SBRP will be entitled to a fixed fee for assisting the company to formulate and propose a plan to creditors (Proposal Fee) The SBRP will be allowed to charge for administering the plan if accepted by creditors (Administration Fee).

The SBRP's independence will be significantly threatened if payment of the Proposal Fee is contingent upon or will be affected by acceptance of the proposal by creditors. In that instance, an SBRP would potentially be incentivised to recommend that creditors accept a less desirable or deficient proposal to ensure payment of the Proposal Fee.

A statutory cap on the level of the Proposed Fee will compromise the integrity of the process and potentially exclude currently registered liquidators from undertaking such engagements. Currently registered liquidators have high levels of training and experience and their participation in the restructuring scheme will add integrity to the system.

To ameliorate these concerns, we recommend the following:

- The regulations should allow flexibility in the way the Proposal Fee is paid. The SBRP should be allowed to enter into third party agreements (such as directors or related parties) to secure payment of the fee as a condition of consenting to the appointment.
- The Proposal Fee should be payable regardless of acceptance of the proposal.
- There should be no cap on the Proposal Fee. Competition amongst practitioners and the market will set an appropriate rate. This issue can be reviewed in 2 years.
- The Proposal Fee and any Administration Fees should be excluded from preference recoveries or claw backs were the company to subsequently be wound up.
- In the event the restructuring plan is terminated, and the company is placed into liquidation, any unpaid Proposal Fee takes first priority from any distributions to creditors.

Eligibility Criteria – Liability Threshold & Group Entities

The regulations are anticipated to include an eligibility criterion whereby a company must have liabilities below a specified amount to qualify for the restructuring process. It is intended that these provisions will benefit small businesses. We can envisage a circumstance in which an entity that is part of a larger group is eligible for the restructuring process as a standalone entity, whereas the group in which it operates is a significantly larger business that is not intended to receive the benefit of the restructuring provisions.

The regulations should include appropriate protections to ensure that entities that were not intended to benefit from the restructuring process are not inadvertently entitled to do so.

Integrity Measure – Adjudication of Creditor Claims

The proposed reforms do not presently indicate whether the review, admission or rejection of creditor claims in a restructuring process is intended to be different to existing processes that apply in liquidation and voluntary administration. To protect the integrity of the restructuring process, an SBRP must have the power to require a creditor to furnish evidence of a debt and to admit or reject creditor claims based upon the evidence provided. This process will present challenges given the 15 business days in which creditors will

have to vote. We recommend that this aspect of the reforms be given careful consideration to strike the right balance between speed and efficiency on the one hand, and integrity and avoidance of fraud on the other.

Eligibility Criteria – Taxation Lodgements

From our experience, we are concerned that the reforms will be used to avoid the payment of tax. There is no fool-proof system to avoid this outcome. To minimise tax avoidance, the Eligibility Criteria set out in 453C and the anticipated regulations should include a requirement that the company's tax lodgements are up to date.

If tax lodgements are not up to date, the company ought to be ineligible for the restructuring process. This will also be of assistance in quantifying the level of creditors and whether the liability threshold has been met in the eligibility criteria.

It should also be a mandatory term of any restructuring proposal that the company meets its tax lodgement obligations throughout the duration of the proposal (if accepted).

Eligibility Criteria – s453C/500AA

These two provisions will result in a company being ineligible to access the restructuring process or the simplified liquidation process if a current director, or a person who has been a director within the preceding 12 months has been a director of another company that has been under restructuring or a simplified liquidation process.

This is an important safeguard to limit the risk of abuse. In our view, the relevant period should be 24 months. The longer period reflects a better balance between encouraging appropriate companies to access the new processes and protecting creditors from systemic abuse.

Essential Term of Proposal – Employee Entitlements

We have considered whether the payment of employee entitlements (most notably, superannuation) should be a specific eligibility criterion for the restructuring process. We have concluded that insistence on payment of employee entitlements as a condition of eligibility may set an inappropriately high barrier to entry, if the concern can be addressed at another point in the restructuring process.

We have concluded that it is more appropriate to require all restructuring proposals to include a mandatory term that outstanding employee entitlements will be paid in full within a relatively short period of the acceptance of the proposal. This would allow, for instance, for the immediate contribution of monies by a third party, should the proposal be accepted.

Simplified Liquidation – Unrelated Party Preferences

The simplified liquidation regime is intended to exclude the recovery of preferences from unrelated parties. We do not support this reform. The recovery of preferences, regardless of the creditor, constitutes an important source of recoveries for creditors.

As we understand it, the simplified liquidation process is intended, at least in part, to attempt to lower the cost barrier for a director to access the liquidation process. In our experience, the ability of the liquidator to recover an unrelated party unfair preference would not make it more difficult for the director to access the liquidation process. If anything, the ability to recover the unrelated party unfair preference would make it more attractive for the liquidator to accept the appointment, and thereby make it easier for the director to wind up the company.

This provision should not be adopted.

General Comments

Free Access to ASIC Registers

The Government has the opportunity to easily impact the costs of insolvency administrations and investigations. This can be achieved by giving registered liquidators and registered trustees free access to ASIC corporate registers.

Current or Former Corporate Trustee – Automatic Appointment

A significant and unnecessary cost incurred in insolvency administrations is the need for the insolvency practitioner to incur reasonable remuneration and expenses in applying to Court to be appointed as a receiver of trust assets.

This cost could be avoided with a statutory appointment as a receiver of trust assets to occur automatically in certain insolvency appointments. This should include an automatic appointment as receiver over the assets of any trust of which the company was a trustee within 24 months preceding the appointment. The current trustee of that trust would have the ability to challenge the appointment by application to Court.

Funding Model

It will be necessary for ASIC to be properly funded to be able to tackle fraud and abuse of the corporate insolvency system, particularly in light of the restructuring reforms.

There are a number of opportunities for ASIC to levy this funding from those who benefit from using limited liability corporations. To properly fund ASIC's investigative and prosecution activities, a fee could be levied from companies:

- At the time of incorporation in addition to other ASIC registration fees; and/or
- At the time the company pays its annual ASIC fees.

We otherwise welcome the Government's intentions in identifying the proposed reforms and moving swiftly on the issues.

Please contact me should you have any questions.

Yours faithfully

Andrew Yeo
Partner & Registered Liquidator