HELPING COMPANIES RESTRUCTURE BY IMPROVING SCHEMES OF ARRANGEMENT

"Focusing on insolvency is aiming at the wrong target"

The objective should be to promote a corporate framework that encourages productive commercial behaviour, assists otherwise healthy companies to survive short-term setbacks and efficiently wind up companies that are failing, before they do too much damage.

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Executive summary

My submission in respect of the Insolvency Reforms Bill for small business suggested the proposed regime resembled a hybrid of a streamlined DOCA / scheme of arrangement, without the court timetables which currently render schemes as being an unsuitable strategy for urgent restructure or turnaround. A follow-up email on 14 September 2020 enquired if amending scheme of arrangement legislation had been considered.

This submission is written as if the proposed amendments to schemes of arrangement will apply to all sizes of businesses and the Safe Harbour protection remains in place as legislated. There is no reason that amendments to the timeframes and court approval process could not be varied so that Schemes of Arrangement would be a viable alternative to Voluntary Administration following appropriate analysis in the Safe Harbour.

Despite the optimism expressed in the consultation document, small business reform as legislated has failed. While the complexity, time and costs have been reduced for owners and directors those burdens and the consequent risks are passed on to the expert who will not be properly remunerated for their expertise, time and risk assumed.

It is probably necessary to accept that small undercapitalised failing businesses are likely to be wound up as:

1. The use of schemes of arrangement, while simpler to legislate, will not differ much in substance to the recent legislated model,
2. The reduced complexity of the small business situation and solution is offset by increased costs and risks attaching to poor financial management and a lack of management expertise, and
3. Most businesses small enough and simple enough in structure are not operated through a corporate structure.

I expect that under both current and future insolvency frameworks failing companies will continue to trade past the point of insolvency resulting in the destruction of owner and creditor capital, loss of employment and other financial costs to the economy.

It is important to understand that just saving a company does not necessarily benefit employees, creditors, and suppliers. There are significant losses incurred by the company during its period of failure that will never be recouped. Without the injection of new capital and management it is unlikely that the failing business will be turned around, and that further losses will be incurred again in the future. More focus on establishing financial cultures within our economy that nurture success is necessary.

The Author

I am formerly a Fellow of the Institute of Chartered Accountants and worked in private practice and banking prior to starting my own consultancy in 1995.

At both Bill Acceptance Corporation and CIBC Australia, subsidiaries of Westpac and the Canadian Imperial Bank of Commerce respectively, I initially held financial management positions before playing key roles in both the planning and implementation of winding up operations due to decisions by the parent companies to close the businesses.

My specialisation in consulting to SME businesses is in the areas of strategy, management, growth, succession, exit and turnaround. I have had lengthy experience in advising and working with SME businesses which were, or were about to become, insolvent.

The type of advice I have provided would now be expected to be sought under the Safe Harbour regime. This should not be confused with “pre-insolvency advisers” who are technical experts familiar with enforcement practices who encourage owners and directors to avoid creditor claims on the business.

I am formerly a member of the Turnaround Management Association and had completed the additional studies to qualify as a Certified Turnaround Analyst, a recognition apparently now abandoned.

Over 40 years I have worked as auditor, taxation consultant, CFO, banker, business consultant and CEO, in a range of business situations including financial administration of businesses under Voluntary Administration. That is a large range of perspectives to draw upon when providing this feedback.

In my submission on Insolvency Reform, I acknowledged the need for urgent legislation and implementation but that, after a period of approximately twelve months to “clear” a backlog, a better system to delineate corporations by size and risk might be considered. However, I also warned of potential pitfalls in addressing the reforms:

1. A lack of information about how these smaller business sectors function,
2. Consultation with organisations such as business and professional associations or government departments, that have little knowledge of the pitfalls of insolvent administrations of SMEs.
3. Not consulting with legal and insolvency practitioners who have a proven track record of working in this sector.

Safe Harbour

It is difficult to address the potential operation of schemes of arrangement, or any other insolvency recovery framework, without addressing the role of the Safe Harbour.

Whether it be in relation to considering a scheme of arrangement, small business recovery, voluntary administration, or liquidation the Safe Harbour will perform a similar function.

No matter how much effort is put in to encouraging owners and directors to seek early professional advice they will mostly continue to ignore the warning signs of failure until they consider insolvency is unavoidable. At that point sufficient time will then be required for owners and directors to consider all options available to protect the business, its assets, its employees, and creditors.

As legislated, the Safe Harbour regime reflects the intentions of the Harmer review, that if prudent directors identified a potential risk of future insolvency, they would take action to implement plans for recovery. The legislation does not contradict any legal precedent or commercial common sense and practices.

Although I do not believe the legislation alters the legal position of directors, it provides reasonable guidance to directors to identify at what point they may be deemed to become liable for trading while insolvent.

This significant uncertainty can be an obstacle to implementing plans for recovery if a director becomes anxious about their personal liability before an appropriate recovery plan can be put in place. Its importance to the confidence of directors in formulating recovery plans without the significant distraction due to of the risks of insolvent trading cannot be underestimated.

Insolvency Facts and Myths

Businesses fail because they are undercapitalised and poorly managed

Numerous retrospective studies of insolvency administrations have identified a long list of typical warning signs and types of events that have triggered an insolvency. However, a bit like an autopsy, underlying factors, past events, negative behaviours are not identified. It is rare that an insolvent company’s problems are not rooted in a lack of capital or poor management.

Conversely a successful turnaround of a failed business will usually require an injection of new capital and new management.

The VA regime has not failed

A Voluntary Administrator is supposed to be appointed when a business becomes insolvent and is unable to pay debts when due. Instead, 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 initially 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 VA is required to compete hard to protect assets for creditors (not to mention, their fees). Legal costs will be significant.

Directors do not seek early advice

A lot of time and resource in the last few decades has been devoted to trying to encourage the owners and directors of failing businesses to recognise and act on warning signs and seek professional advice. It is believed that this will increase the chances of saving a viable business and avoiding the loss of employment.

This has had no discernible effect on the behaviour of principles of failed businesses, and in fact it appears that distributions to creditors and the number of businesses salvaged continues to decline. I believe this is likely due to businesses trading right up until cash runs out, and the legal costs and complexities of administrations increase.

I do not believe changing regimes will change this behaviour as owners are driven more by the impact on their ego of public failure, and the fear and uncertainty of the consequences of insolvency which may include potential loss of home, personal assets and family disruption.

A lack of funds, or just reluctance to pay fees for professional advice, will also deter owners and directors from taking early action.

Banks and the ATO will look after their own interests at the expense of other creditors

Prior to the GFC directors might have been forced to act 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.

Directors do not wind up companies prematurely because of insolvent trading penalties

The penalties for trading insolvent are severe, which is not unreasonable given that if a director knows that the company is insolvent, and incurs new debts, it is little different to simple fraud or theft.

However there have been very few successful actions as it can be difficult to conclusively identify a date of insolvency and prove that the directors incurred new debts even though they knew the company was insolvent.

It would be unusual for directors to prematurely appoint an insolvency practitioner. Presumably this would occur where it is in the interests of the company or the directors to do so. Note that Harmer did envisage that there would be situations where early appointment of an administrator, even before the company becomes insolvent, may provide the best outcome for the company and its creditors.

A company saved is not necessarily viable and may fail after restructuring

It is unlikely that businesses that are restructured, or revert to the owners, under a DOCA will be successfully turned around because there is no new capital, and the same poorly performing managers continue to run the business. There will be little prospect of future growth and it is likely that the business will continue to operate on the edge of solvency.

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.

Operation of Proposed Amended Schemes of Arrangement

Moratorium (Q1 – Q6)

it makes sense to me that an amended scheme of arrangement regime run parallel to the VA regime as an alternative choice of action to be determined during the Safe Harbour period.

On that basis moratorium should apply from the date of proposal of the scheme of arrangement, which I would assume is mailed as per the initial VA communication. The terms and conditions applied to debts covered by the moratorium will be determined by the Scheme of Arrangement.

I agree there should be some form of priority for suppliers who continue to provide credit to the company in the period to voting on the scheme.

Timeframes and approval

The use of schemes in relation to creditors is unusual due to the protracted timeframes and court approval process. I assume it is proposed that timeframes be amended to match those of the VA regime which are sensitive to the urgent needs of distressed companies.

I have suggested that a Liquidators Review Panel or similar be considered to expedite approvals and other guidance to all parties.

Director control of business

For whatever reason, possibly due to self-interested lobbying, considerable emphasis is being placed on the advantages of existing directors continuing to control the company.

There is certainly advantage in retaining the benefits of accumulated corporate knowledge and expertise as well is the natural incentive they may have to recover the company’s position.

This must be balanced against the fact that the same directors managed the company to the point of insolvency.

Possibly this will need to be managed by the independent scheme administrator under terms and protocols set out in the proposed scheme of arrangement. Early action to address issues may indicate that the directors can be relied upon to act in the interests of the company. The later they have left taking action, leaving the company in a more distressed situation, the more likely I believe there is a risk directors may put their own interests first.

Creditor classes

A desirable feature of the current framework is the requirement for each class of creditors to agree to the scheme. On the other hand, that also increases leverage of certain groups to hold other classes of creditors and members to ransom.

It would also expose the scheme to inequities caused using cross-border structures or different corporate entities being used to shelter group assets from creditors. It was noted in the consultation paper that some jurisdictions use a ‘cross class cram down’ to provide equity equitable treatment for all creditors.

Given that it is desired that the Scheme of Arrangement regime promotes Australia as an attractive place to invest. I am concerned that the impact of a ‘cram down’ might undermine the legal and commercial rights of a particular class of creditor. Such disputes reported in the media are usually in relation to reducing the rights and financial value of debts owed to foreign shareholders and financiers who are less able to influence local authorities.

Public Companies

I do not believe that listed public company directors should be entitled to any additional protections anticipated by the Safe Harbour review or amendments to the Scheme of Arrangement legislation.

Public company directors enjoy several advantages over their SME counterparts. The company only lists after exhaustive checks and reviews of its plans and forecast performance by expert legal and accounting professionals. They continue to have the benefits of significant shareholder capital, a significant existing business, sophisticated systems, experienced management and professional advisers.

There is a considerable risk that delays in taking action are affected by share price and reputation consequences. A public company director’s reputation should be based on their performance as a steward, not on protections afforded by insolvency legislation or regulation.

Liquidators Review Panel

A major problem that has grown through the life of the VA regime is the increasing involvement of lawyers and consequent case precedent. In addition, given the shrinking pools of assets, sophisticated legal advice is often used to attack the VA or otherwise promote the interests of the creditor or owners above others.

This was probably always unavoidable and will continue to be a problem with any new or revised insolvency framework.

Apart from the financial issues significant delays can be caused by the necessity to resolve conflicts in court or even for insolvency practitioners to seek confirmatory advice on a proposed course of action to protect their own interests.

I am suggesting that the feasibility of forming a separate panel of experienced or retired insolvency experts be considered. The panel would report to ASIC, assume some of the load of court approvals, and provide guidance to all parties on the possible outcomes of the proposed actions.

Promoting Healthy Business Behaviour

There are significant costs of business failure, mainly being the destruction of the owners’ and creditors’ capital, loss of employment, and the reimbursement by the taxpayer of shortfalls and employee entitlements.

Less obvious to external parties and reviewers of raw data, is the intangible loss of intellectual property in the delivery of products and services and the use of the means of production, the loss of the means of production and the wastage of skills.

The likelihood is that no matter how much energy, time and resources is invested in improving the methodology of distributing the remnants failed businesses, we will not significantly reduce the losses that will be incurred or the costs of completing the insolvency administration.

The government should be promoting the formation of business capital, influencing the training and behaviour of directors and enabling the business community to allocate resources in the most efficient way to support the government’s national economic objectives.

Commercial Problems Require Commercial Solutions

Employee entitlements and the implied government capital guarantee

The initial legislation for GEERS (now FEG) was in response to an immediate and pressing problem following the collapse of a large employer without the cash reserves to make payments to employees who were stood down.

The liability for leave entitlements unpaid by insolvent companies should only have been borne by the government for an initial transition period.

Any company that commences business and cannot immediately provide cash or surety for its employee expenses is not operating profitably or has commenced business with insufficient capital to support its start-up. In order to support employees across the country the government has effectively guaranteed the shortfall in company capital that should have been allocated to meeting employee entitlements.

The liability to employees by failing companies accumulated by the year 2000 was apparently too large an amount for the government to consider a transitional period for employers to build cash reserves to meet these liabilities.

In my opinion any businesses receiving financial support from any future government initiative should be immediately required to commence transition to fully funding leave entitlements.

In future if new businesses are not profitable or insufficiently capitalised to fund the provision for entitlements, then they should not be in business. Better they go broke straight away than years later with many creditors and unfunded employee entitlements.

Sources of capital

Business Funding

I am concerned that initiatives like the Business Development Fund are compromised by a government culture which will not provide sufficient accountability and security over the return of funds. There will be an initial emphasis on investing as much of the funds as quickly as possible. At the same time a design feature of the fund is to limit its influence on the owners and boards of the borrowing company.

This may infringe on an equitable return to the fund (which could be reinvested) due to shareholdings that do not represent an appropriate economic interest. There is a lost opportunity to provide close supervision and management control to develop management expertise within the company. A particular risk is that funding is intended for significant expansion opportunities where the Fund is reliant on the owner/manager's previous success managing a smaller business pre-expansion.

I believe significant opportunity is available in distressed situations to fund turnaround on a commercial basis and securing the government/taxpayer position by working with the banks, ATO and the Government (re FEG) who have the most funds at risk in any insolvency.

Banks and the ATO

For many years prior to the GFC the banks and the ATO provided a level of protection to all creditors by monitoring the financial health of the failing business. Given the passage of time required to obtain information and negotiate with the company, both the banks and ATO could only take action at a fairly advanced stage of failure.

Neither will want to be seen in the current environment to be taking action against a struggling business. Nor is it in their financial self-interest to do so.

Current ATO practice would appear to be to continue to negotiate payment plans until such time as the company no longer has cash to meet them. On liquidation the ATO is currently determined to deny repayment of any references, and in many cases, there will be insufficient funds to pursue them.

Given low interest rates and booming property values banks, irrespective of the overall financial position of their client, are well covered against loss. Rather than take action and incur the risks and costs of appointing a Receiver there is an advantage in leaving directors to appoint a VA, and maintain their security position over property.

I fully understand their position, but note their special relationships with a failing company, having a high level of access to its management and financial information. There is a loss of efficacy in that while they are in a position to limit the losses to other creditors and employees, they can stand aside and protect their interests ahead of others.

The FEG contingent guarantee

Under this scheme the government is caught in a situation where, if the company fails, it will be liable to pay the employee entitlements with recourse only back to the diminished assets of the company. The irony is that the amount of FEG, if invested into the company, could save it.

That does create additional risks should the recovered company fail in the future with employee entitlements still outstanding. I would envisage this could be remediated by:

- Funding been contingent on being matched from other independent sources such as the Business Fund, banks or new investors
- The government being repaid its investment prior to any other payments to new investors, lenders or related parties
- The recovering company would be required to immediately enter a transition period to build a funding reserve to meet employee entitlements

Social licence to trade

As things stand, just about anyone can open a business with a minimal outlay and proceed to run up liabilities which will never be repaid.

By contrast use of the road is heavily policed with training and licensing requirements dictating the size of vehicle that can be driven. For example, if I am a cyclist and unlikely to cause significant damage to others, then no license and registration is required. 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 to reduce the incidence of business failure and insolvent trading. Apart from wide agreement on the requirements, it would be a logistical nightmare to deliver training and examination. There is also an elephant in the room, where on any given day, there will be a media story about an educated or experienced director breaking the law or caught in a reckless act.

Some black and white prescriptive legislation is required to protect the business population when they are trading with failing companies.

This could be a simple traffic light system, 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.

Business Finance Exposure to Property Values

There is much global speculation about the availability of money, low interest rates and consequent inflated asset values. Australian property is recognised globally as an asset class which could be overvalued.

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 risky for the government to intervene to support prices in the face of falling global asset prices.

The government needs to facilitate the means for the market to find solutions which protect or mediate the risks of falling values on business borrowers and financiers.