NEW RESTRUCTURING AND INSOLVENCY PROCESSES FOR SMALL AUSTRALIAN BUSINESSES

29 September 2020 | Australia
Legal Briefings – By **Paul Apáthy, Natasha McHattan, Darran Devlin and Raymond Sun**

The Australian Federal Government has announced significant insolvency law reforms that will affect small businesses with liabilities of less than $1 million. The reforms are expected to commence on 1 January 2021 and will introduce, among other measures, a new debt restructuring process and liquidation pathway for small businesses which the Government intends to be simpler, more flexible and more efficient than existing processes.

IN BRIEF

On 24 September 2020, the Australian Federal Government announced significant insolvency law reforms that will affect small businesses with liabilities of less than $1 million that find themselves in financial distress. The changes are expected to commence on 1 January 2021 and come in response to the economic downturn caused by COVID-19, which has dramatically impacted the revenues of many businesses and is anticipated to result in a significant increase in insolvencies, particularly as Government support measures are dialled back.

The reforms introduce a new debt restructuring process and liquidation pathway for small businesses, among other measures, which the Government intends to be simpler, more flexible and more efficient than existing processes.

A copy of the Government's announcement together with a supporting fact sheet providing further details of the proposals are available here.

The reform package has three key elements:

- **debt restructuring process**: a new "debtor-in-possession" debt restructuring process for incorporated businesses with liabilities of less than $1 million which is intended to be simpler, more flexible and more efficient than voluntary administration and which aims to maximise small businesses' chances of survival;

- **streamlined liquidation pathway**: a new streamlined liquidation pathway available to incorporated businesses with liabilities of less than $1 million which is intended to reduce time and cost in the liquidation process and which aims to ensure better returns for creditors; and

- **other measures**: other complementary measures which are intended to reduce the burden on the system and to assist restructuring and insolvency practitioners to respond to the expected increase in the volume of insolvencies resulting from COVID-19.

At this stage the Government has only provided a fairly high level description of the new debt restructuring process and other changes being proposed. A significant number of questions therefore remain as to how this new process will work, and its ultimate impact in practice. However, given that the reforms are intended to commence on 1 January 2021, the details of the regime will need to be finalised, and draft legislation introduced, rapidly in the next few months.

In this article we summarise the key aspects of the law reforms announced by the Australian Federal Government and make some initial observations in respect of some potential issues with the proposals, focussing in particular on the new debt restructuring regime.

AN AUSTALIAN CHAPTER 11?

The new debt restructuring process has garnered the most attention to date, being described in the Government announcement as "drawing on some key features of the Chapter 11 bankruptcy model in the United States."

The proposed debt restructuring regime involves what could be described as a "debtor-in-possession" regime that allows directors to stay in control of the company with the benefit of a moratorium on creditor enforcement whilst the debt restructuring proposal is developed and then put to creditors. At a very high level this is conceptually similar to the US Chapter 11 bankruptcy process.

However, based on the information released by the Government to date, the debt restructuring aspects of this proposal appear to bear more similarity to a Part IX debt agreement (applicable to individuals) under the *Bankruptcy Act 1966* (Cth), a deed of company arrangement (as part of a voluntary administration process) or the United Kingdom's company voluntary arrangement (CVA) procedure. The debtor-in-possession moratorium aspects, on the other hand, appear to bear more similarity to the United Kingdom's new standalone corporate moratorium procedure (introduced under the *Corporate Insolvency and Governance Act 2020* (UK)).

IS A BETTER TOOL NEEDED TO RESTRUCTURE SMALL BUSINESSES?

Currently voluntary administration is the main formal statutory procedure available to Australian companies looking to restructure or reorganise their debts.[1]

The Government indicates that it considers voluntary administration to be a "one-size-fits-all" approach that is not well suited to smaller businesses. It notes that the cost of voluntary administration can consume most of the value of a small business' assets, and that small business owners may be reluctant to place control of their business into the hands of an external administrator. It also cites a 2015 Productivity Commission report that found that almost 60% of companies that enter voluntary administration are deregistered within 3 years.

The economic impact of the COVID-19 shutdowns on small businesses appears to have spurred the Government's reform response in this space. The Government notes that many small businesses significantly increased their level of debt in order to remain in business during the COVID-19 outbreak. As a result, it considers that in order for small businesses to recover, they will need "a simple, cheap and faster means to restructure their debt."

FEATURES OF THE NEW SMALL BUSINESS DEBT RESTRUCTURING PROCESS

The reforms will introduce a new "debtor-in-possession" debt restructuring process available to "incorporated businesses"[2] with liabilities of less than $1 million.[3] The stated intent of the new process is to give small businesses a better chance at successfully restructuring their debt.

Under this new restructuring process, the directors of the company will work with a small business restructuring practitioner (**SBRP**) to develop and implement a debt restructuring plan. While the directors and SBRP develop the plan, directors will retain control of the company, a moratorium will prevent creditor enforcement and the company will be permitted to continue trading in the ordinary course of business. The plan is then voted on by creditors and will be approved if more than 50% of the company's creditors by value vote in favour of it.

There are few details on what can be provided for in a plan. However, the Government's summary states: "Key creditor rights will be preserved. For example, there are no changes to the rights of secured creditors, and similar types of debts are treated consistently."

The role of the SBRP will include:

- determining if the company is eligible for the new debt restructuring process;
- assisting the directors of the company to develop and implement a debt restructuring plan;
- reviewing the financial affairs of the company;
- certifying whether the SBRP considers the company can meet the proposed repayments under the plan and has properly disclosed its affairs; and
- managing repayments once the debt restructuring plan is in place.

The Government's fact sheet indicates that the debt restructuring process would operate as follows:

- **Initial contact with SBRP**: The directors of the company approach an SBRP (who must be independent) to discuss the company's eligibility for the new debt restructuring process and the SBRP's fees for helping the company to develop a debt restructuring plan (this must be a flat fee).
- **Appointment of SBRP**: The directors of the company pass a board resolution to appoint the SBRP.
- **Notice to creditors**: A notice of commencement of the debt restructuring process is provided to creditors.
- **Moratorium**: On commencement of the debt restructuring process a moratorium begins:

    - unsecured creditors and "some" secured creditors are prohibited from taking action against the company;
    - personal guarantees cannot be enforced against the directors or their relatives; and
    - there is a restriction on the operation of *ipso facto* clauses similar to that applying in voluntary administration.
- **Development of a debt restructuring plan**: The directors and the SBRP work together over a 20 business day period to develop a debt restructuring plan. During this time, the directors retain control of the company and may continue to trade in the ordinary course of business. The SBRP also develops a remuneration proposal to cover the administration of the debt restructuring plan once in place (which will operate as a percentage fee of disbursements made under the plan).
- **Payment of employee entitlements**: The company must pay any employee entitlements which are due and payable before the debt restructuring plan is circulated to creditors.[4]
- **Circulation and certification of the debt restructuring plan**: The SBRP circulates the debt restructuring plan and supporting documents to creditors, and certifies whether or not the company can meet the proposed repayments under the plan and whether the company has properly disclosed its affairs.
- **Creditors vote on the debt restructuring plan**: The creditors have 15 business days to vote on the debt restructuring plan with all creditors voting as one class. Related party creditors are not entitled to vote. If more than 50% of creditors by value vote in favour of the debt restructuring plan, the debt restructuring plan is approved. If approved, the plan binds:
    - all unsecured creditors; and
    - secured creditors to the extent their debt exceeds the realisable value of their security interest.
- **Outcomes for the company**: If the plan is approved, the company continues to trade in the ordinary course of business and the SBRP administers the debt restructuring plan

according to its terms. If the plan is not approved, the debt restructuring process ends and the company may elect to either enter voluntary administration, access the new liquidation pathway or enter the existing liquidation process.

TRANSITIONAL RELIEF

The Government appears to be concerned that when the temporary insolvency protections in respect of insolvent trading and statutory demands expire on 31 December 2020, the insolvency profession may not be ready to handle the large influx of new debt restructuring cases on 1 January 2021.

To address this issue the Government is proposing a temporary transitional regime under which an eligible company could declare its intention to access the debt restructuring process and then obtain a further 3 month period of protection in respect of insolvent trading liability and statutory demands. A company would be able to make such a declaration between 1 January 2021 and 31 March 2021.

A NEW LIQUIDATION PATHWAY

In addition to the new small business debt restructuring process the reforms also propose a ‘cut-down’ liquidation pathway for small businesses.

The new liquidation pathway modifies the investigation, creditor meeting and reporting requirements which apply to the current liquidation process to reduce time and cost.

Under the new liquidation pathway, a small business may still appoint a liquidator to take control of the company and realise the company’s assets for distribution to creditors and other stakeholders. However, key modifications to the existing liquidation process include:

- reducing the circumstances in which a liquidator can seek to recover an unfair preference payment from a creditor that is not related to the company;
- only requiring the liquidator to report to ASIC on potential misconduct where there are reasonable grounds to believe that misconduct has occurred;
- removing requirements to call creditor meetings and the ability to form committees of inspection;
- simplifying dividend and proof of debt processes; and
- maximising technology neutrality in voting and other communications.

The new liquidation pathway will not affect the rights of secured creditors and the statutory rules as to the payment of priority creditors such as employees.

OTHER MEASURES

As the temporary insolvency law reforms near their end, the Australian Federal Government has announced further permanent and temporary measures to support the system and restructuring and insolvency practitioners to deal with the expected increase in the number of businesses seeking to restructure or liquidate.

These further measures include:

- temporarily waiving fees associated with registration as a registered liquidator until 30 June 2022 to reduce barriers to entry for insolvency practitioners;
- removing red-tape in relation to the registration of insolvency practitioners;
- revamping key parts of the *Corporations Act 2001* (Cth) to make it technology neutral; and
- introducing a new classification of insolvency practitioner whose practice will be limited to the new debt restructuring process only.

INITIAL OBSERVATIONS AND QUESTIONS

COVID-19 has already had a severe impact on many parts of the Australian economy, and it is expected that the effect on businesses will become more acute as Government support is withdrawn in the coming months.

In this context, a framework that can promote orderly restructuring of debts in an efficient and equitable manner, and ultimately help to preserve viable businesses is very much to be welcomed.

However, the proposed reforms involve a significant change to Australia’s insolvency landscape. The introduction of a debtor-in-possession moratorium is a marked step away from the “creditor friendly” approach traditionally applying in Australia. A “debtor-led” approach does however reflect a broader global shift in this direction in recent years, exemplified by both the United Kingdom and Singapore introducing debtor-in-possession moratoriums (and indeed even the general trend in the Australian market in recent years towards debtors working through their own problems rather than bank initiated appointments).

There will be significant complexities to be addressed and resolved. At this stage we only have a high level description of these new procedures, and a significant number of questions remain around how the reforms will work in practice.

The detail around these issues, and clarity on the operation of the new regime within the context of Australia's existing insolvency processes, will be an important part of ensuring that the new regime is set up in a manner which supports its success.

We note below a number of initial key issues on the proposed regime which will need to be addressed to ensure the new process achieves its intended outcomes:

- **$1 million threshold**: Questions remain as to how liabilities will be calculated to determine if the regime will apply. For example, will contingent, future or unquantified liabilities (such as damages) be included? An understanding of this detail is important to ensure there is some certainty as to eligibility at the outset. Questions also arise as to whether there is any principled reason why the regime could not also be made available to larger businesses, given the $1 million threshold would appear to limit the application of this regime to very small businesses.

- **Insolvency requirement**: Will there be any other requirements to commence the process? For example, will the company need to be "insolvent or likely to become insolvent" (as required for directors to commence voluntary administration)? If the process is intended to allow earlier intervention, then it will be important to ensure it is accessed in good faith.

- **The SBRP**: What will the SBRP's role involve and what qualifications will they be required to hold? What steps will the SBRP play in the preparation of the restructuring plan? Will the SBRP supervise trading of the business during the operation and what will be the legal consequences of an SBRP certifying a plan (could a SBRP be personally liable if the plan is not achieved)?

- **Moratorium period**: Further detail will need to be provided as to the operation of the proposed moratorium under the new regime. Is the scope of the moratorium intended to be the same as what applies in a voluntary administration? Will there be an exception for security over all or substantially all of the company assets? Will there be a restriction on lessor repossessions? Will transactions incurred during the moratorium period be liable to being set aside as voidable transactions in a subsequent liquidation? How will the regime interact with rights under the *Personal Property Securities Act 2009* (Cth), including the timing of vesting of unperfected security interests?

- **Trading and debts incurred during moratorium**: How will debts incurred by the company during the moratorium period be dealt with? Will these have any priority in a subsequent liquidation? Can they be compromised under the plan? Will creditors be willing to extend any form of credit to the company during this period in practice or will the company need a liquidity buffer? Is obtaining “DIP funding” during this period permissible and if so, are there any requirements on the terms (for example, can new security be granted)? Does the SBRP have any responsibility or control over the company’s trading during the moratorium period?

- **Employees and taxes**: The requirement that employee entitlements are paid and tax returns are up to date appears to mirror the requirements to access the insolvent trading safe harbour. Exactly what employee entitlements will need to be paid? What will happen if (as is often the case) companies do not have the liquidity to be able to pay these amounts at the outset of the process?

- **The restructuring plan**: Will each restructuring plan be bespoke or is it intended that the legislation will contain a standard form of plan or minimum requirements to help with efficiency and consistency? What will be able to be done under a plan – will it be broad and flexible like a DOCA (allowing things like debt for equity arrangements, sale processes or debt rescheduling) or will it be fairly simple and restricted to making prescribed cash payments to creditors? Will the plan need to result in a better outcome for creditors than liquidation and would the SBRP need to give an opinion on this (similarly to in voluntary administration)?

- **Effect of plan on third parties**: Will the restructuring plan only be able to release the debts of the company that are subject to the plan or will it also be able to release debts owed by third parties? Importantly, how will guarantees granted by directors or shareholders be addressed under this new regime (given their prevalence in small business)? Will the plan bind creditors even if they didn’t receive notice of the debt restructuring process?

- **Voting on the plan**: Will the SBRP be responsible for determining creditor claim amounts for voting purposes and will there be a formal proof process? Will voting occur at a meeting of creditors (whether in person or virtual) or will there simply be a period during which creditors may vote? Is the majority threshold determined based on those voting or creditors as a whole? Given there appears to be no requirement that a majority of creditors by number support the plan (in contrast to a deed of company arrangement), how will the interests of minority creditors be protected if there is one creditor that holds a majority of the debt and potentially controls the vote (especially if the position of that one creditor differs in some material respect from other creditors).

- **Secured creditors**: To what extent can or will secured claims be compromised by the process? The fact sheet indicates that security may need to be valued, and a secured creditor’s debt will be treated as unsecured to the extent it exceeds the value of the collateral. Who will carry out this valuation, how will it be done and how will this impact the security going forward? To what extent will the company be able to deal with or sell secured assets during the moratorium period without the consent of the secured creditor?

- **Challenging the plan**: Will there be grounds for setting aside a plan if it unfairly prejudices a creditor, if there is inadequate disclosure or there is some other procedural irregularity? Would such a challenge require Court intervention and could this be done in a cost effective manner?

- **Exit from debt restructuring**: How and when does a company exit from the restructuring process? If the plan is successful, can the company simply resort to ordinary operation and if so, when does this occur, who decides on the plan's "success" and on what criteria? If the plan is not approved or not proposed in the relevant timeframe, will there be a special pathway for the company to go directly into voluntary administration or liquidation and who determines this? What happens if the plan fails or is breached by the company after it is approved?

- **Government funding**: What role is there for the Government in this process? The unfortunate fact is that many small businesses enter insolvency with little or no funds to cover the costs of the process, let alone meet any creditor claims. Consideration may therefore need to be given to whether the Government will meet any of the costs of either the restructuring or liquidation process – there has been discussion, for example, of a "voucher" system for small business owners to get some initial costs covered by the Government. It is also important to bear in mind that an effective restructuring and insolvency system is an important public good, which should not only help rescue viable businesses so as to support the broader economy but also ensure that corporate malfeasance is investigated and addressed. It may not be realistic to achieve these outcomes entirely by way of private funding provided through the assets of the company.

ENDNOTES

1. Whilst creditor schemes of arrangement are used for very large debt restructurings, the cost and timeframes associated with this procedure (which involves, among other things, two court hearings) tends to makes it impractical for SME businesses. There is no standalone "company voluntary arrangement" procedure in Australia.

2. It is unclear whether this term is intended to simply refer to Australian incorporated companies, or whether it has application to other business structures.

3. The Government states that around 76 per cent of companies that entered into external administration in 2018-19 had less than $1 million in liabilities. It is unclear on what basis these liabilities were calculated.

4. The fact sheet also indicates that the company must have filed all of its tax returns. These requirements appear similar to those applicable in respect of the insolvency trading safe harbour.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

PAUL APÁTHY
PARTNER, SYDNEY

+61 2 9225 5097
paul.apathy@hsf.com

MARK CLIFTON
PARTNER, SYDNEY

+61 2 9225 5745
Mark.Clifton@hsf.com

NIKKI SMYTHE
PARTNER, SYDNEY

+61 2 9225 5154
Nikki.Smythe@hsf.com

NATASHA MCHATTAN
SPECIAL COUNSEL, SYDNEY

+61 2 9322 4701
natasha.mchattan@hsf.com

DAVID JOHN
PARTNER, PERTH

+61 8 9211 7742
David.John@hsf.com

MARTIN MACDONALD
PARTNER, MELBOURNE

+61 3 9288 1913
Martin.MacDonald@hsf.com

ALAN MITCHELL
PARTNER, MELBOURNE

+61 3 9288 1401
Alan.Mitchell@hsf.com

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.