# Australia's landmark new rescue and liquidation processes for SMEs

September 2020

*'By adopting key aspects of the US Chapter 11 bankruptcy process, we will introduce a single, simpler, faster, more cost-effective insolvency process for small business.*

*It will see our system move from a rigid, one-size-fits-all "creditor in possession" model to a more flexible "debtor in possession" model.*

*This will enable small business owners to remain in control, provide them with an opportunity to restructure and ultimately increase their chances of surviving this COVID crisis.'*

Treasurer J Frydenberg, 24 September 2020

## Importance of the SME sector to the Australian economy

Having effective SME insolvency laws is important to the Australian economy:

- 97.5% of businesses in Australia employ less than 20 employees
- Small businesses (< 20 employees) employ 4.7M people in Australia, representing 44% of the total number of people employed in the private, non-financial sector
- SMEs have been particularly badly affected by the pandemic

## Adoption of the IMF's three phase approach to addressing the pandemic

The proposed reforms continue Australia's adherence to the IMF's three phase approach to addressing the financial distress aspects of the pandemic.

The first phase was the introduction of emergency interim measures intended to provide a breathing space for both debtors and institutions. This has been very successful in Australia, with the number of companies entering external administration down by 46% from April to July 2020 compared to the corresponding period in 2019.

The second phase – which we are currently in – is one of evaluation and planning. It is evaluation of the adequacy of existing insolvency laws and institutions to be able to successfully address the debt overhang caused by the pandemic and to facilitate the re-emergence of a thriving economy once the emergency measures are lifted. And it involves planning what is required to both "flatten the curve" of insolvency proceedings once the interim emergency measures are lifted, and to address the shortcomings identified in the evaluation process.

By the commencement of the third phase – announced by the Treasurer as 1 January 2021 – the necessary law reform and capacity building will be in place to enable the debt overhang to be addressed, and the economy to recover as swiftly and effectively as possible by resolving the pandemic induced financial distress.

## The need for SME reform in Australia as part of the pandemic response

International best practice in relation to SME insolvency requires a balance between fairness and efficiency, to:

- Support the rescue and restructure of **viable** companies and businesses that are experiencing financial distress that have a realistic prospect of trading out of their difficulties; and
- Ensure that companies facing endemic operational and financial failures – including where that is exclusively due to the pandemic induced disruption - can be liquidated as quickly and cheaply as possible, so that the value of remaining funds in the company can be maximised and distributed to creditors, and from there reinvested to support new ventures and projects.

Voluntary administration under Part 5.3A of the *Corporations Act 2001* (Cth) (***Corporations Act***), followed by the approval and implementation of a deed of company arrangement (**DOCA**), is Australia's existing formal rescue process for insolvent companies, and it too sought to achieve these aspirational goals. Yet in practice over the last 25 years, the experience has been that once a company enters voluntary administration, it rarely emerges. The average return to unsecured creditors has been less than 5 cents in the dollar, and a return of less than 11 cents in the dollar was produced in 97% of formal insolvencies. This is hardly an impressive scorecard, and not one that would inspire confidence in the regime's ability to successfully address the debt overhang challenges that will require urgent attention from 1 January 2021.

Voluntary administration takes a "one size fits all" approach to financial distress, subjecting the insolvent café or community swimming club to exactly the same regime and processes as were recently applied to the insolvency of Virgin airlines. In this respect, and others, our laws departed substantially to what might be described as international best practice.

Interim insolvency relief measures introduced by the Australian Government in March 2020 – a moratorium on insolvent trading liability, an increase in the threshold for creditors to issue a statutory demand (from $2,000 to $20,000) and an increase in the time for a company to respond to a statutory demand (from 21 days to 6 months) – originally due to expire on 22 September but now extending until 31 December 2020, have helped businesses "survive" the initial demand and supply shocks caused by COVID-19. But these measures are, necessarily, a stop gap mechanism and it has been clear for some time that more meaningful, enduring law reform has been needed to achieve greater flexibility in Australia's insolvency laws and incentivise the rescue and restructure of viable businesses.

Indeed, there has been great concern in the insolvency industry that the interim measures created something of a 'zombie company' pandemic, in which a number of entities have been able to survive only with the benefit of Government support, even without having any realistic prospect of independent trade in the long-term. There is now a plan and a pathway towards ensuring that such concerns will be addressed.

## The proposed new rescue laws for financially distressed SMEs

On 23 September 2020, the Australian Government announced that it will introduce new legislation – to take effect from 1 January 2021 – that will for the first time introduce a new rescue process exclusively for SMEs.

In essence, the new SME rescue procedure is a debtor in possession model drawing on features of the United States Chapter 11 *Bankruptcy Code* restructure process.

In summary, the new procedure will be:

- Directors of companies with outstanding debts of less than $1 million can appoint a small business restructuring professional (**SBRP**) to develop a restructuring plan;
- Once this occurs, there are enforcement moratoria that prevent unsecured creditors – but not substantial secured creditors – from enforcing their claims against the company;
- Directors remain in office and can exercise their usual functions – the debtor in possession model that operates under Chapter 11 in the United States – while the restructuring plan is developed over a 20 business day period;
- Directors must ensure all outstanding taxes and employee entitlements are paid before the plan can be submitted to creditors (similar to the preconditions that currently apply to directors invoking the safe harbour from insolvent trading under section 588GA of the **Corporations Act**);
- Creditors have 15 business days to vote on the plan once it is submitted. In considering their vote, creditors have the benefit of the SBRP's opinion on the company's likelihood of repaying outstanding debts;
- Creditors vote as a single class – unsecured creditors and, if a deficiency remains after deducting the value of their security, secured creditors – and the plan is deemed to be approved if it receives the support of at least 50% of voting creditors. However, the plan does not prevent secured creditors from enforcing their claims over the company's property.

- Notably, related party creditors are **excluded** from voting in an effort to prevent the risk of abuse and monopolisation of the vote; and
- If approved, and subject to secured creditors being able to enforce their rights if they choose, the plan is then implemented by directors with the assistance of the SBRP. If the plan is rejected, directors will need to consider voluntary administration or liquidation.

## Comparison of new SME rescue regime to recent UK amendments

The apparently limited nature of the moratorium while a plan is being prepared under the new laws, and the inability to bind dissenting secured creditors to a plan submitted to creditors, may restrict the potential for the SME rescue alternative to significantly advance the number of successful debt restructurings for small businesses.

In these respects, the pre-plan moratorium can be contrasted to the wide-ranging moratorium that applies under the informal workout process introduced in the United Kingdom on 26 June 2020 under the *Corporate Insolvency and Governance Act* (UK), pursuant to which directors apply to the court for an initial 20 business day enforcement moratorium, which can be extended for a further 20 business days without creditor consent or indefinitely with creditor consent, while a restructure is negotiated. The moratorium is broad-based and extends to the enforcement of claims by landlords and secured creditors, while the new Australian process appears to leave open the prospect of secured creditors enforcing against assets of the company that are critical to the success of a rescue attempt.

Additionally, the circumstances in which a SBRP is appointed also need to be considered closely. A similar condition to that applying in the United Kingdom, requiring the SBRP to form the view the new SME process would be likely to lead to a successful restructure, would be worthwhile.

## New simplified liquidation process for SMEs

Apart from the new SME rescue process, the Australian Government will also introduce with effect from 1 January 2021 a simplified liquidation process. Again, SMEs with outstanding debts of less than $1 million are able to go through a much more cost effective and quick process, under which liquidators are not required to submit section 533 reports unless there are reasonable grounds to believe there has been corporate misconduct. Additionally, there is a simplified dividend and proof of debt process and creditor meetings and the formation of committees of inspection do not apply. These modifications will save critical scarce capital, thereby maximising the dividend for creditors, while also removing the disincentive currently faced by liquidators in accepting an appointment and completing statutory obligations without any prospect of being paid for their fees.

Nevertheless, in circumstances where corporate misconduct is manifest, there are still insufficient assets to pursue investigations, and in these cases we believe the Australian Government ought to consider increasing the funding available for liquidators under the Assetless Administration Fund so that they can apply for amounts to investigate and commence enforcement proceedings where appropriate.

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