INSTITUTE OF PUBLIC ACCOUNTANTS®

Submission to The Treasury: Corporate insolvency reforms – Regulations and Rules

November 2020

24 November 2020

The Manager
Business Conduct Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: matthew.bowd@treasury.gov.au and MCDInsolvency@treasury.gov.au

Dear Sir/ Madam

Corporations Amendment (Corporate Insolvency Reforms) Regulations 2020 AND Insolvency Practice Rules (Corporations) Amendment (Corporate Insolvency Reforms) Rules 2020

The Institute of Public Accountants (IPA) welcomes the ongoing reforms to the insolvency laws and specially to support small business through the difficult economic conditions imposed by COVID-19. We also welcome the opportunity to offer our views on the exposure draft Regulations and Rules. We make this submission further to our submission dated 12 October 2020 with respect to the exposure draft on the Corporations Amendment (Corporate Insolvency Reforms) Bill 2020, as it is vital for all of these reforms to be considered and implemented collectively.

In preparing this submission, we have undertaken consultation with members who are Registered Liquidators, certified turnaround specialists and members who do not currently practice in these sectors.

The IPA is one of the three professional accounting bodies in Australia, representing over 40,000 accountants, business advisers, academics and students throughout Australia and internationally. Three-quarters of the IPA's members work in or are advisers to small business and SMEs.

Our main points:

1. The Regulations and Rules should provide a streamlined process to enable qualified and competent accountants to become registered as Small Business Restructuring Practitioners (SBRP).
2. The draft Regulations and Rules do not currently reflect the intention to introduce a simplified and cost-effective process.
3. Government should commit to an early review of the reforms (legislation, regulations and rules) to ensure they are working as intended.

Overall

We are of the view that the draft Regulations and Rules are overly complicated and onerous. Combined with the short timeframe they are unlikely to result in a cost-effective outcome and we believe the same applies with the ongoing requirements once the Restructuring Plan is in place.

Regulation 5.3B.16(4)(5): strict liability

The SBRP is required to sign a certificate stating they have undertaken certain investigations, within a short timeframe. They are required to make 'reasonable inquiries', however, this is ambiguous, uncertain and open to judgement. Even though the penalty is not considerable, we believe it should not be a strict liability offence. We do not agree with the reasons provided for making this a strict liability offence and counter that rigour and integrity would not be undermined if strict liability did

not apply. In any event, guidance may have to be provided by ASIC as to what constitutes 'reasonable inquiries' in various circumstances. We also note **Regulation 5.3B.37** which states that a restructuring practitioner for a Restructuring Plan is not liable for actions done in good faith and so on. We believe this should apply to 'reasonable inquiries'.

Reporting
Despite the intention to reduce reporting, we believe that in essence, there is a reasonable amount of reporting required, which in turn will increase the cost. This is another requirement that could be part of an early review.

Voidable transactions
The director must sign a declaration that there have been no voidable transactions, the tax reporting obligation must be up to date and employee entitlements must have been cleared. We are advised by our Registered Liquidator members that even though there are exemptions for unfair preferences under this process, for most companies, there will almost always be voidable transactions. If the distressed director signs the declaration and it is later found there were voidable transactions, or tax and employee obligations, then they are subject to civil penalties. This may be either an unfair outcome or an unintended consequence.

Regulations and Rule 20-2: registration for restructuring practitioner
We believe it will be difficult to qualify for registration, which would be contrary to the intention to increase the pool of qualified people. The need to demonstrate 'the capacity to perform satisfactorily the functions and duties of a registered liquidator', required under Rule 20-2 would preclude many otherwise competent 'recognised accountants' from applying. Whilst this may depend on how ASIC interprets this requirement with respect to the role to be performed, we believe that further guidance should be included in the Rules and that, as recommended in our previous submission, a recognized accountant should be able to successfully complete a relevant and appropriate qualification in order to demonstrate their capacity to perform the required functions. A detailed example of the type of relevant course has been provided. If an additional requirement were considered necessary, then we suggest an experience requirement of say five years in practice as a recognized accountant. Otherwise, only Registered Liquidators will qualify, and this is a diminishing pool.

Concern has been expressed by Registered Liquidator members that the qualifications, experience, knowledge and abilities requirement for a restructuring practitioner application do not reflect the requirements and obligations of these practitioners. This is based on the new and existing legislation and processes being complex and particularly given Part 5.7B appointments mirror many technical and statutory obligations of Part 5.7A appointments, without the commercial trading obligation. In order to be able to certify the restructuring proposal and advise directors regarding voidable transactions (for the purposes of the director's declaration), the restructuring practitioner will have to have an in depth understanding of these types of transactions. There is concern about the outcomes for creditors, who are themselves often small businesses. Given these reasons, we believe it is even more critical to simplify the processes and systems. Members have also expressed the need to ensure public support for the reforms, which depends on having competent and qualified practitioners.

Regulation 5.3B.01: contingent creditors
The inability of contingent creditors to prove will result in these being excluded from any proposal. All of these may result in post-restructure insolvency events and fails to give the company a 'fresh start' as intended:

- This may result in a post-restructure having these claims then crystalise and being enforced against a company and being able to get their debt paid in full after all of the other trade creditors have their claims compromised.
- Will potentially exclude landlord claims for unpaid rent for the balance of a lease where a lease is abandoned but the property has yet to be re-tenanted.
- Will exclude debts which have been guaranteed by the company to third parties.
- Will exclude warranty claims which have yet to be brought.

Regulation 5.5.04: preferential payments
It would appear that a preferential payment that is made within 3 months for no more than $30,000 is not a preference. However, lower amounts/ preferences paid in the preceding 3 to 6 months are able to be recovered. This would appear an odd outcome as to why this has been inserted. It may be that it was intended to change preferences from being 6 months and for unlimited amounts to being for 3 months and for unlimited amounts to be being for over $30,000, however, this is not how we would interpret these draft provisions. Clarity is required as the explanatory statements do not make it clear.

Regulation 16(2)(d): referrals and independence
This provision appears to indicate that a practitioner can take referrals from brokers for restructuring work and can pay the brokers for referrals. This is contrary to section 595 which prevents inducements for all other external administrators. This has the ability to give the impression of bias and allows a situation of unregulated people operating in this space and paying referral fees, which we believe is against the policy intent of the reforms. Further, this is contrary to decades of court rulings on the importance of independence; and potentially undermines the credibility of the process and of the reforms. Creditors will see little value in a 'certified' proposal if they don't view the person who has certified it as being independent. This lack of independence is also inconsistent with the aims of the recently introduced insolvency law reforms aimed at improving creditor confidence in liquidators and the work they perform. Further clarity is sought to ensure that independence of all parties is maintained at all times.

Regulation 16(2)(e): independence
Again, we seek clarity on this provision to ensure independence of the parties. It appears from the current draft that the restructuring practitioner can have a related entity which is owed money by the insolvent company (refer to comments above on the need for independence). This related party is to be treated as an 'excluded creditor' pursuant to Regulation 01. Presumably, this would allow an Insolvency Practitioner's (IP) related entity to do the 'pre-insolvency' advice and then refer the company through to the IP to do the restructure proposal. There is a requirement that a liquidator be disqualified from taking an appointment if they are owed $5,000 or more – this does not extend to a related entity of the IP. Such debts would normally conflict an IP but there is no independence requirement for a SBRP. Reliance would have to be placed on the independence requirements in the Accounting Professional and Ethical Standards, to which recognised accountants are subject. However, even though they are enforced by the professional accounting bodies, they do not have the force of law. To put the matter beyond doubt, a specific independence requirement should be included in the Regulations or Rules.

We wish to avoid the potential situation where any ambiguity is exploited, leading to unfavourable practices and outcomes, especially for unsuspecting small business owners in distress. Arguably, there is scope for the pre-insolvency advisor to dispose of business assets and then pass the business onto the SBRP, who would then verify the existence of the current asset position and certify the proposal to creditors which would then look attractive given the business no longer has any assets

(or few assets) on hand. The creation of a 'Chinese wall' between these two IP related entities would allow for the SBRP to certify the proposal with 'plausible deniability', resulting in a poor outcome for creditors.

Regulation 20: disputed debts

The process for dealing with disputed debts appears cumbersome and requires numerous notices/ adjustment reports being sent to all creditors. If several creditors dispute the debt, then this is likely to result in numerous adjustment reports being circularised. This is likely to create confusion in the mind of the receiving creditors about which proposal they are voting upon; with the return to each creditor diminishing as the potential creditor pool grows.

Regulation 25 (b): employee entitlements

The reforms require that all debts be paid proportionately. There does not seem to be a priority for accrued employee entitlements (eg leave). It is noted that a requirement of a Restructuring Plan is that all 'employee entitlements' as determined under section 596AA(2)&(3) are paid, however, this section only includes wages, superannuation, retrenchment payments and injury compensation. Accordingly, it would appear that a Plan cannot deal with employee annual leave or long service leave. However, it is not clear whether these other items are specifically excluded, unless classified as a 'contingent debt', rather than being apparently classified as a 'contingent entitlement' which is arguably something different.

Rule 60-1C: remuneration

We believe there should be flexibility to revisit remuneration prior to the actual appointment of a SBRP. The complexity of the process and the potential extent of Court involvement (which is unlikely to be anticipated or known at the time of appointment), mean that it is unlikely that the conduct of these administrations will be certain or will always follow a standardised process.

- For example, directors provide a list of creditor claims. In the experience of our Registered Liquidator members, it is unlikely that this list will be correct. There is then a back and forth process to correct amounts with creditors and a possible need to communicate information back to the creditor body.

In the event that a Restructuring Practitioner was replaced (eg died or had to resign due to illness or perhaps was deregistered) then there is no capacity for the new Restructuring Practitioner to have their remuneration considered and agreed.

Rule 60-1D: unfunded work and contingencies

The Regulations require that a Restructuring Practitioner be paid by reference to a percentage of the distributions made. This presumably would be to cover the cost of doing this distribution work. However, if a new creditor appears (as contemplated by Regulation 29) after the proposal is circulated, then the Restructuring Practitioner is required to adjudicate on this claim (Regulation 29(5) &(6)) and write to all creditors (Regulation 29(7)(a)) notifying them of this new creditor. This work would be unfunded given the percentage fee for the post-Plan work would be set having regard only to the estimated costs of the SBRP doing the distribution and so on. In addition, what happens if after all of the adjudication process is done and the Proposal fails? This is unfunded work by the SBRP.

The current remuneration setting process means that practitioners will have to factor in a large contingency, which is not in the interests of the company or creditors. If they don't factor in a sufficient contingency, there is a risk that the Proposal may fail as the practitioner will not have sufficient funds to take matters to Court if necessary.

Rule 70-60(2A): lodging the Plan with ASIC
At present the Plan is only lodged with ASIC if ASIC requests it. We suggest it should be compulsory for the Plan to be lodged with ASIC to provide greater rigour and transparency in the process.

Continuing Professional Development (CPD)
The Insolvency Rules paragraph 5 state that the practitioner must comply with the CPD of the respective accounting body but in paragraph 6 it prescribes the CPD requirements. We assume that the higher requirements will apply.

Virtual meetings
We welcome the inclusion of provision for virtual meetings; and note the need to ensure the requirements are technology neutral.

Position of directors
There appears to be no mechanism for a director to appeal or have input into the decision regarding the validity of a creditor's claim. Our Registered Liquidator members have advised that normally this would not be needed, however, given it is a debtor-in-possession model there may need to be scope for this. For example, a director lists a creditor for $10,000; however, upon circularisation the creditor sends in a vote against the proposal and is claiming $75,000 which would be enough to ensure that the proposal does not proceed. If the SBRP agrees with the creditor (perhaps with the intention of avoiding a costly dispute and also it is unlikely that the SBRP's costs will be covered for this additional work) then there is no scope for appeal by the director. This may still occur even where the SBRP has made 'reasonable inquiries'.

Position of creditors
Based on the experience of our Registered Liquidator members, we believe there could be issues in a situation where: if 25 per cent of unrelated creditors don't agree to the Restructuring Plan it can't proceed. The Plan requires all creditors with admissible debts or claims to rank equally and be paid proportionately under the Plan, including secured creditors to the extent of their unsecured debt. Secured creditors can vote for the full dollar value of their debt in equal ranking to unsecured creditors. If they vote for the Restructuring Plan, they will be restricted in dealing with their security interest. In certain circumstances the SBRP would first have to ensure they had the support of the secured creditor.

Consequences of failed Proposal
If the Proposal to creditors is not accepted or terminates, there is no outcome for creditors despite the company being insolvent (ie there appears to be no penalty to a company which fails to comply with its Proposal or being put into liquidation like what would happen if a Deed of Company Arrangement is not accepted). This aspect should be clarified.

Simplified liquidations
If a liquidator receives a notice under section 500AB from a creditor not to follow the simplified process, there does not appear to be a mechanism for a liquidator to opt out despite receiving this notice. Regulation 5.5.07 provides no remedy for this situation.

There does not appear to be a mechanism for a liquidator to opt out of a simplified liquidation process – rather there is only a prescriptive list in section 500AC(1)(b) and Regulation 5.5.07 of when an IP must cease.

There is no power for ASIC to require a liquidator to lodge a report – unlike the Court under Regulation 5.5.05.

The above aspects should be considered and provision made in the reforms.

Sections 500A and 500AB
Creditors have 20 business days to direct the liquidator not to adopt the simplified liquidation process. Unfortunately, liquidators only have 20 business days in which to adopt the process (section 500A(2)(a)). Accordingly, a liquidator may never be in a position to adopt the simplified liquidation process – this needs to be clarified.

Schedule 2 of the Act
This provides that for a Petitioning Creditor, the threshold is now $20,000 and 6 months in which to respond for those that are eligible for temporary restructure relief – it is not clear how a creditor is going to know whether the debtor company is eligible.

Proposals without meetings
There is no scope to hold meetings, even at the liquidator's discretion, in a simplified liquidation. Under the current legislation meetings are required to be held for the purpose of certain approvals from creditors (eg compromise of debts, agreements longer than 3 months). If a company has a debt that the liquidator wants to compromise, they will be unable to do so and will have to continue to pursue recovery or write it off in full. It would also restrict any ability to seek litigation funding to voidable transactions as the agreements ordinarily extend beyond 3 months. A simplified solution could be considered, allowing a discretion to hold meetings, which can be held virtually; and/ or allowing the liquidator to make a decision without liability.

Impact on Registered Liquidators
There is concern that SBRP's should not be able to carry the title of Registered Liquidator in the event there is a negative impact on Registered Liquidators, who have far more onerous registration and ongoing obligations. It may also cause confusion for small business owners and consumers who may not be aware of the significant differences. It would be preferable for SBRPs to identify themselves as such in order to avoid confusion and ensure the distinction is made.

As mentioned in our previous submission, using any terms with the word 'liquidation' may have negative connotations and be unfavourable for businesses in distress.

Commitment to review
As recommended in our previous submission, we believe that the Government should commit to a full review of the reforms (legislation, regulations and rules) in 12 months (and no more than 24 months) from their commencement. Given their importance, the potential for unintended consequences and the fact they will have been rushed into commencement, we strongly believe that a full review is warranted. It is critical to the survival of many small businesses that these reforms operate as intended.

Members who have decades of experience in the insolvency sector have advised that unintended consequences and other issues will emerge within the first six months. This is certainly sufficient time to assess whether the registration of SBRPs, on which the reforms rely, is operating as intended.

If you have any queries or require further information, please don't hesitate to contact Vicki Stylianou, Group Executive, Advocacy & Policy, either at vicki.stylianou@publicaccountants.org.au or mob. 0419 942 733.

Yours faithfully

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