Australian Small Business and Family Enterprise Ombudsman

2 December 2022

Committee Secretary

Parliamentary Joint Committee on Corporations and Financial Services

PO Box 6100

Parliament House

Canberra ACT 2600

via email: corporations.joint@aph.gov.au

Dear Sir/Madam,

Corporate Insolvency in Australia

We welcome the Parliamentary Joint Committee on Corporations and Financial Services (the Committee)'s inquiry into corporate insolvency in Australia. We note that the last comprehensive review of Australia's insolvency laws was the Harmer Report of 1988. While many of the recommendations from that review remain relevant today, the economic landscape has significantly changed through the last two decades. As small businesses continue to grow in Australia, there is an existing and increasing need to review and improve insolvency processes.

There are many reasons why a small business may become insolvent, with many outside of the business' control. Entrepreneurs with great ideas may not always succeed the first time. In fact, many of our greatest companies and inventions were started by people who failed the first time. Yet, the current insolvency system is not sympathetic to honest failure and genuine prospects for recovery of the business or business owner. The lifecycle of a small business should include a simple, early exit strategy should the business begin to become unviable. While reform of the broader insolvency ecosystem is important and welcome, for best results we encourage the Committee to consider the role of financial acumen and access to quality advice prior to the point of the business becoming insolvent.

We held multiple roundtables with industry experts and insolvency practitioners in preparing this submission. We make the following recommendations against the Terms of Reference (ToR):

1. Establish response protocols that will support businesses in future emergencies.
2. Improve financial acumen and access to quality advice to better support small businesses.
3. Undertake reform of the broader insolvency system.
4. Review and improve the small business restructuring provisions.
5. Apply learnings from international best-practice.
6. Improve other supporting insolvency legislation.
7. Clarify the treatment of trusts under insolvency law.
8. Review insolvency practitioners' fee structure and responsibilities.
9. Review government agencies' role in insolvency.

Further detail on these recommendations follows.

Recent and emerging trends in the use of corporate insolvency and related practices in Australia

The emergency protocols enacted by the Australian and state and territory governments in response to COVID-19 allowed many otherwise-viable small businesses to survive the challenges presented by the pandemic. These response protocols contributed to significantly lower insolvency numbers than those in a 'regular' year, with 4,912 corporate insolvencies in 2021-22, following 4,235 in 2020-21. These are the lowest levels of corporate insolvency since 2000-01. By comparison, in the year prior to the pandemic, there were 8,105 administrations (2018-19).[1]

With the resumption of Australian Taxation Office (ATO) debt collection, compounded with inflation and interest rate rises, stretched global supply chains, rising costs of materials and energy, and labour shortages, corporate insolvencies have started to return to pre-pandemic levels. Insolvency levels in the construction sector are returning to pre-pandemic levels the quickest of all sectors, accounting for 26% of total corporate insolvencies in 2021-22. In the September quarter of 2022, 605 construction firms entered external administration or appointments, up from 445 in the June quarter, and 271 in the March quarter.[2] This is a record high in the current Australian Securities and Investments Commission (ASIC) insolvency statistics time series, which commences in the September quarter of 2013. For context, the accommodation and food sector – the sector with the second highest rates of corporate insolvencies – had 15% of the total.[3]

Insolvency can occur in any sized company, but it is particularly devastating for small- and medium-sized businesses, which have less cash flow to mitigate against disruptions, are often underinsured, and have fewer options and legal tools and protections than larger companies. Small businesses also face a disproportionate burden in navigating the full suite of legislation governing insolvencies, as they are often time poor, and have less access to specialist advice than their larger counterparts. Insolvencies become increasingly problematic when they are high in a particular industry, elevating levels of uncertainty and contagion, and may set off a chain event felt not only by the company and its employees, but by the secondary businesses and contractors involved with the insolvent company.

ASBFEO Case Study 1: Chain effect of insolvencies

A home improvement business entered an exclusive contract as an authorised dealer with a wholesaler for a product. After 12 months, the small business received customer requests for warranty replacement as the product had alleged faults. The wholesaler initially helped with warranty repairs but within two years, the business owner received an email from the wholesaler that they had ceased trading, no longer had assets and the company was being wound up.

The small business owner was placed in a difficult financial position once the wholesaler closed, as future warranty claims would put a financial strain on the business. The small business engaged legal advice throughout the process which added additional costs to the dispute. The original product supplier purchased the company assets from the wholesaler business but claimed it had no legal obligation for future warranties and therefore there was no pathway for resolving the issue with the existing businesses.

This case demonstrates the cascading impacts of insolvencies on secondary businesses.

[1] ASIC, 'Insolvency Statistics', *Series 1 Companies entering external administration*, accessed 17 November 2022
[2] *Ibid*
[3] *Ibid*

Recommendation 1. Establish response protocols that will support businesses in future emergencies *(ToR item 1)*

Consideration should be given to creating emergency protocols which support viable small businesses in future emergency scenarios, such as pandemics, natural disasters, global conflicts or other crises. The current insolvency framework assumes that the failure of a business is due to poor management of that business. Yet, when a crisis shocks an economy, even the best managed businesses may not survive. While governments may offer a raft of packages to support small businesses and allow them to recover from such shocks, the assistance is not guaranteed, is inconsistent across jurisdictions, varies with each shock and often delays, rather than mitigates, the impacts.

We suggest the Committee considers, as previously recommended by this office, the establishment of a Small Business Debt Hibernation program, which encapsulates protocols such as moratoriums, tax and other fees freezes, and government financial support.[4] This would provide confidence for small businesses in knowing that, where an exogenous shock negatively impacts their business, there is an option to hibernate their business debts, restructure and continue trading. The Small Business Debt Hibernation program could also include tools to allow businesses to assess their viability and assist with future planning.

Ensuring creation of emergency response protocols which support small and family businesses would assist in providing a timely and effective fiscal response to future crises, help protect otherwise viable businesses from becoming insolvent, and better support the Australian economy.

Recommendation 2. Improve financial acumen and access to quality advice to better support small businesses *(ToR item 4)*. Consideration should be given to:

- Ensuring key documents are available in simple English with less technical wording
- Improving the type of information available
- Making information available in one place and easily accessible
- Utilising existing 'touch points' around business formation, registration and reporting and Director identification to share 'better practice' guidance and links to business acumen resources and sources of assistance.

We recommend the Committee considers mechanisms to help small businesses improve their financial acumen and awareness of signs of possible insolvency, as well as their access to quality advice. There was strong support among our stakeholders for preventative measures to support small businesses improvement of financial acumen prior to experiencing viability issues.

Compared to big businesses, small businesses have fewer tools and resources, and less time to get across the full suite of legislation and regulation in relation to business management, including awareness of insolvency processes, small business restructuring provisions and directors' responsibilities. Most business performance resources encourage early assessment of financial viability but do not provide the necessary support to do this effectively. A recent ASBFEO survey as part of our Inquiry into Small Business Natural Disaster Preparedness and Resilience found that 44% of small businesses did not have a formal business plan.[5] There is also no distinction between

[4] ASBFEO, *Insolvency Inquiry Report,* July 2020, p. 6
[5] Survey conducted 10-20 June 2022, with 1,040 responses. Respondents were small businesses who had experienced a natural disaster in the last 5 years. These natural disasters were broadly defined including floods, drought, fires, and pandemics (including COVID-19).

who a small business owner should seek advice from regarding their insolvency process – whether ASIC or the Australian Financial Security Authority (AFSA).

ASBFEO Case Study 2: Confusion about which agency is responsible

> The directors of an incorporated entity declared personal bankruptcy. ASIC removed the office holders who had become bankrupts but continued to seek payment for past debts and imposed new fines. The directors contacted the ASBFEO, hoping we could help deregister the business. We advised that the matter was outside our jurisdiction and encouraged the directors to engage with AFSA. However, after contacting ASIC, ATO and the bankruptcy trustee, no agency appeared willing to take control of the entity to deregister it. The business also originally struggled to get support from AFSA. This complexity is difficult for a time-poor, under resourced small business to navigate.

Due to the perceived negative stigma surrounding insolvency and a lack of accessible information regarding individual business performance, industry benchmarks and insolvency processes, small businesses may not realise they have viability issues or continue trading after viability issues arise. Improving businesses' financial acumen and skills will reduce the productivity drag from the continued trading of unviable or dormant businesses, free up underutilised assets and improve skilled workforce mobility. We recommend the Committee considers improving financial acumen and awareness of insolvency by:

- Ensuring key information documents are written in simple English with less technical wording. Governments should ensure information is made available in other languages to better support businesses from culturally and linguistically diverse backgrounds.
- Improving the type of information available. For example, information on business planning, how to do early assessments of business viability, and insolvency options and procedures.
- Making information available in one place and easily accessible. Currently, insolvency information is scattered across multiple platforms, which makes it difficult to find and easy to miss potentially critical information. This may result in accidental non-compliance.

Adding an insolvency module to existing business management and administration courses would upskill current and future business owners. This will improve their awareness of insolvency processes and necessity for early, regular business viability assessments.

These recommendations focus on the self-help aspect, however more needs to be done to also improve businesses' access to external help. This may include upskilling appropriate small business advisers to better manage the business viability and highlight early concerns regarding the solvent nature of a business. Business owners usually already have a trusted relationship with an adviser and may be more receptive to restructuring advice from their known adviser rather than engaging an insolvency practitioner. We note that such upskilling would need to embed measures to prevent advice that supports illegal activities, like unlawful phoenixing, such as public disclosure of any misconduct by the relevant industry association, or regulation.

There is merit in providing upskilling programs or additional qualifications to enable other types of practitioners to provide restructuring advice. There is potential to target training options towards women, to enable more balanced gender representation in insolvency practices. Of the 649 registered liquidators in Australia in the September quarter 2022, only 60 – or 9% – were female.[6]

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[6] ASIC, *Insolvency Statistics – Series 4*, 'Quarterly registered liquidator statistics', accessed 18 November 2022

Consideration should also be given to how government can improve extension services, or small business access to appropriate and timely expert advice that includes navigating business viability, succession, and timely and resource-efficient exit processes. We welcome the additional funding provided by the Australian Government for the Small Business Debt Helpline and New Access for Small Business Owners mental health support program. However, targeted support is necessary to help small businesses in assessing the financial health of their business before they reach crisis point and while restructuring is still possible. This could be achieved by establishing a business viability program, as previously recommended by this office, to make it easier for small business owners to access and navigate expert business advice and support.[7] Such a program would provide a viability service to improve businesses' financial acumen, forward planning skills, and understanding of insolvency processes. It would also provide an opportunity to identify cash flow or other problems early and provide tools to remedy them, such as through restructuring, which may avoid an insolvency.

While we acknowledge the ATO's existing business viability assessment tool, this is an automated tool, and we recommend ensuring small businesses have access to targeted person-to-person advice. Further, we note concerns that there may be hesitancy by small businesses to engage with the ATO tool for fears of disclosing information that could be used by the ATO against them. The ATO's 'cashflow coaching kit' resource, designed to be worked through with an accountant/ bookkeeper, would benefit from a self-help, self-paced version.

ASBFEO Case Study 3: Lack of awareness of insolvency procedures

A small business (contractor) entered a contract with a business that provided design solutions to clients. The contractor noticed two outstanding invoices, with another two falling due shortly. The parties negotiated payment dates for the invoices, but negotiations were not honoured.

The contractor sought assistance from the ASBFEO, and soon learned that the business was going into voluntary administration. Administrators advised the contractor they would contact him regarding the process for handover of client work and the payment of invoices.

The contractor was not familiar with an insolvency process, steps involved or timings. We provided the contractor with information from ASIC detailing the voluntary administration process, to help him understand the process and highlighting the need to have any outstanding invoices with the administrator for payment.

Recommendation 3. Undertake reform of the broader insolvency system *(ToR item 2)*

We recommend the Committee considers reform of the broader insolvency system. Current insolvency practices in Australia are costly, complex and difficult to navigate, and would benefit from simplification. Australia's insolvency system does not adequately take account of the unique characteristics and challenges of the small business sector. It seldom considers an insolvent company's longer-term prospects, its competitiveness, assets, or brand value, and is geared towards closure and liquidation. The system seldom allows for the possibility that, through restructuring or assistance, the company could return to profitability and preserve the interests of creditors, investors, business owners and other key stakeholders including staff.

The current insolvency system assumes a neat distinction between a business and an individual, whose distressed financial circumstances do not intersect with one another. Small and family

[7] ASBFEO, *Quarterly Report: Q1 (January-March) 2022*, p. 11

businesses are rarely so neatly arranged. A small business is less likely to be an incorporated entity and more likely to be a blended 'structure' of independent contractors, self-employed persons, or a partnership operating through a trust. Even for incorporated entities, Directors guarantees, personal collateral used to secure finance, and statutory sanctions that create a personal Director obligation or liability, add to the blending. The utility of the insolvency system would benefit from a better recognition of this blending of business and personal interests.

We are also concerned by the unknown plight of enterprises and small and family businesses that 'discontinue' each year without being formally closed. What is their plight and how are economic interests and obligations 'settled' when the business no longer operates?

Ensuring the insolvency system balances the needs of all parties whilst being timely, affordable and effective is key to a healthy economy and helps to drive entrepreneurship, innovation, competitiveness and productivity. Creating an insolvency framework that adequately incorporates the unique characteristics and needs of small businesses would assist productivity growth and provide for a dignified and cost-effective experience for small business exits, while preserving the entrepreneurial spirit so they can one day try again.

There is broad support among our stakeholders for the simplification of the broader insolvency regime, with suggested reforms including:

- Simplifying corporate insolvency legislation in Chapter 5 of the *Corporations Act 2001* (Cth). The Corporations Act is complex and difficult to understand. It stretches 3,900 pages and includes over 1,000 unique defined terms, with 570 of those defined more than once.[8] This legislation is accompanied by the Corporations Regulations 2001, itself over 1,300 pages in length. Simplifying this legislation will make it easier for small businesses to navigate it on their own without involving insolvency practitioners.
- Increasing emphasis and duty on optimising and preserving value in the interest of all stakeholders (including creditors, owners, investors and employees) throughout the insolvency process, and avoiding asset 'fire-sales' to simply satisfy secured creditor interests.
- Simplifying reporting and documentation requirements for insolvency practitioners, as current requirements mean reports are time-intensive and costly to develop. Reporting could instead be considered in the context where it delivers clear benefits to creditors. This would ease insolvency practitioners' time burden and result in lower costs to businesses.
- Transitioning reporting to a digital model, including business accounting to later assist liquidators in calculations, and in insolvency reports to the ASIC. Digital reporting will increase efficiency and drive down costs, resulting in time savings and increased productivity for insolvency practitioners, thereby reducing costs to clients. It is also a future-proof solution in an increasingly digital age.
- Simplifying compliance, with recommendations for a template that enables practitioners to do simplified checks for minor offences without involving the courts. This would ensure courts only deal with major offences, thus reducing costs for small businesses. Attending courts for minor offences could be considered in the context where there is a clear benefit to creditors.
- Facilitating a broadening of 'restructuring practitioners' beyond insolvency professionals to encourage business development professionals with an understanding of insolvency laws to become registered.

[8] ALRC, *Undue complexity in Australia's corporations and financial services legislation*, November 2021

The Treasury has recently commenced important work on exposure draft legislation to reduce the complexity of the *Corporations Act 2001*, and the Australian Law Reform Commission (ALRC) has an ongoing inquiry into the potential simplification of financial services laws in Australia. We recommend the Committee aligns any proposed changes to the *Corporations Act 2001* in the context of insolvency with existing work.

ASBFEO Case Study 4: Lengthy liquidation process, with small returns to unsecured creditors

A local domestic tourism operator and travel agent became an unsecured creditor to a business that entered liquidation arising from COVID-19. The small business was concerned about the length of the liquidation process and was in dire need of funds in liquidation.

The business wanted us to enquire about speeding up the liquidation process. We engaged with the liquidator, who advised that there were significant delays (upwards of 6 months) waiting for Fair Entitlements Guarantee (FEG) to consider employee entitlements. The liquidator advised that in following the *Corporations Act 2001*, it could not take further action, nor provide timely or consistent updates, whilst FEG was looking into the matter.

In the end, FEG determined that employees were owed significant funds. This resulted in small returns to unsecured creditors, rather than the higher amount the complainant had hoped for.

Recommendation 4. Review and improve the small business restructuring provisions *(ToR item 2)*

We recommend the Committee undertakes a comprehensive review of the small business restructuring provisions, with a view for their improvement and increased utilisation. The provisions deliver better outcomes to the business and its creditors, provide small businesses with a chance to survive, and reduce the stigma of a restructuring procedure.

The *Corporations Amendment (Corporate Insolvency Reforms) Act 2020*, effective January 2021, introduced reforms for the small business restructuring and simplified liquidation processes. The simplified liquidation was intended to make the liquidation process faster and cheaper for small businesses, while the small business restructuring provisions sought to enable more small businesses to quickly restructure and, where restructure was not possible, assist businesses to wind up faster. Under the small business restructuring provisions, business owners retain control of the business while they develop a plan to restructure the company's affairs with the assistance of a restructuring practitioner.

While the intentions of the *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* were sound, this legislation is also complex and expensive for most small business insolvencies. Its uptake remains low, with 70 debt restructuring processes in 2021-22, out of a total of 4,912 insolvency appointments, or 1.4%.[9] Uptake increased to 83 in the September quarter of 2022, but still accounts for only 4.0% of corporate insolvencies. The low uptake of the provisions could also be due to limited awareness of the provisions among small businesses and hesitancy from insolvency practitioners to take on these cases due to the fee structure.

A comprehensive review of the small business restructuring provisions will clarify their effectiveness and reasons behind the low uptake. The review could also consider improvements to

[9] ASIC, 'Insolvency Statistics', *Series 1 Companies entering external administration*, accessed 17 November 2022

ensure the provisions are more accessible and effective for small businesses. In addition to simplifying the legislation, consideration should be given to:

- Reviewing the eligibility requirement for small business owners to meet all their tax and employee entitlement obligations, as many of these businesses may already be facing debt repayment issues when they become insolvent
- Increasing the liability threshold of $1 million or changing it to a percentage to capture more businesses, such as those on long-term contracts that may exceed the threshold
- Increasing the timeframe to develop the restructuring plan from the current 20 days and
- Expanding eligibility of the provisions to sole traders.

ASBFEO Case Study 5: Sole traders not covered by corporate insolvency law

A small business paid $3,800 to a sole trader for goods they did not end up receiving. The small business tried to contact the sole trader directly, however did not receive any response. They then sought assistance from the ASBFEO and, after discussing possible options with our office, were informed through word of mouth that the sole trader had been forced into bankruptcy (the small business was unable to verify this). Because sole traders are not covered under corporate insolvency law, the small business had little chance of recovering monies owed.

Recommendation 5. Apply learnings from international best-practice *(ToR item 3)*

Research undertaken by the European Research Studies Journal highlights that internationally, Australia's insolvency regime is considered to have one of the least debtor-friendly laws.[10] In contrast, the US, Canada and the UK are often cited as model systems in international insolvency panels such as the United Nations Commission on International Trade Law, and are well regarded internationally. We recommend the Committee seeks to apply learnings from best-practice examples from these international regimes into Australia, for example:

- Providing a singular legislative framework for personal and corporate insolvency, as in the case of the US, Canada and the UK.
- Prioritising restructuring over bankruptcy and giving business owners ownership of their business during the restructuring process, as in the case of the US (Bankruptcy Code, Chapter 11) and Canada.
- Minimising the impact of a debtor's insolvency by ensuring equitable distribution of the debtor's assets or, where possible, by rehabilitating the debtor, as per Canada's regime.
- Providing a possibility of automatic releasing from debt after completion of bankruptcy or restructuring proceedings, as per Canada's regime.
- Licensed insolvency trustees to drive insolvency processes (not courts like in the US), with most of these trustees being accountants, as per Canada's regime.
- Trustees to be paid after the person files bankruptcy, with no upfront fees, as per Canada's legislation.

[10] European Research Studies Journal, *Bankruptcy Law Severity for Debtors: Comparative Analysis Among Selected Countries*, 2020

- Ensuring the bankruptcy process is followed by credit counselling, as per Canada's regime. This focuses on rehabilitation, so that business owners are less likely to repeat the problem and provides business owners with skills to support entrepreneurship.
- Assuming the honest debtor as per Canada's regime, which is designed to give a fresh start.

Singapore's insolvency regime also ranks high on the international scale and warrants further consideration. Singapore's *Insolvency, Restructuring and Dissolution Act 2018* consolidated the personal and corporate insolvency and restructuring laws, established a regulatory regime for insolvency practitioners and enhanced Singapore's insolvency and restructuring laws, such as the strengthening of the debt restructuring regimes.

Recommendation 6. Improve other supporting insolvency legislation *(ToR item 2)*
Consideration should be given to:

- Joint personal and corporate insolvency legislation
- Simplified *Personal Properties Securities Act 2009* (PPSA) and Personal Properties Securities Register (PPSR)

Consideration should be given to the establishment of a singular legislative framework for personal and corporate insolvency

Australia has separate personal and corporate insolvency legislation. Structured appropriately, managing the insolvency process through one system may be more efficient, considering the close link to personal insolvency for a small business owner. As discussed earlier, small business and personal finances are uniquely intertwined. For example, it is common practice for small business owners to use personal assets, such as the family home, as collateral in obtaining business loans. In September 2022, 49% of outstanding business finance to small businesses was residentially secured.[11] The close link between corporate and personal insolvency is also confirmed by AFSA's September 2022 data, which shows that 35.7% of all personal insolvencies were business related.[12]

Several previous reports recommended an inquiry into the impacts of merging personal and corporate insolvency legislation. These include the ALRC's *General Insolvency Inquiry* 1988 (Harmer Report), Trade Practices Commission's *Study of the Professions* 1992 and Treasury's *Review of the Regulation of Corporate Insolvency Practitioners* 1997 reports. The reports suggested that the benefits of merging the legislation would lead to:

- cost savings through economies of scale
- a common approach to registration procedures and guidelines
- consistency in decision-making and policy alignment and
- ability of regulators to deal with the insolvency case holistically across all relevant aspects.

A singular legislative framework for personal and corporate insolvency aligns with international best-practice examples, such as that of the US, Canada, the UK and Singapore. The *Insolvency Law Reform Act 2016* sought to harmonise corporate and personal insolvency law. These harmonisation changes were scheduled for review 5 years after the date of implementation in 2017.
No announcement about a review has been made to date.

[11] Reserve Bank of Australia, *Lending to Business – Business Finance Outstanding by Business Size and Interest Type*, Table D14, accessed 18 November 2022
[12] AFSA, *New personal insolvencies drop by 8.1 per cent nationally year-on-year*, 28 November 2022

We recommend that the Committee explores the potential for a merged corporate and personal insolvency system further in its inquiry.

Consideration should be given to the simplification of the PPSA and PPSR

The PPSA and PPSR provide important protections for small businesses in the event of insolvency by registering their security interest over goods or services so they cannot be sold to pay off creditors. When a business becomes insolvent, unsecured creditors – most of whom are small businesses – are often left at a disadvantage because they are the last to be paid from the liquidated asset pool. Registering on the PPSR gives the small business extra rights in the registered property. However, the PPSR is complicated, expensive and the application process is easy to get wrong. The recent work of the Behavioural Economics Team of the Australian Government (BETA) to improve accuracy in PPSR registrations highlights this complexity. The BETA found that 22.3% of PPSR transactions made by users who completed the original form were incorrect, and 12.8% of transactions were inaccurate after behavioural interventions.[13] Consider also:

- *Forge Group Power Pty Ltd (in liq)(receivers and managers appointed) v General Electric International Inc* [2016], which highlights the severe consequences of failing to register a security interest, but also the complexity of PPSA terminology and difficulties for foreign companies to engage in the PPSR process. In this case, General Electric lost assets worth US$44 million because they did not register them on the PPSR.
- *OneSteel Manufacturing Pty Limited (administrators appointed)* [2017] NSWSC 21, which highlights the severe consequences that may follow from seemingly innocuous mistakes made when registering security interests. The error that gave rise to the proceeding was the use of an Australian Business Number (ABN) instead of an Australian Company Number (ACN) to identify the grantor in the financing statement.

Simplifying the PPSR will make it easier and more accessible for small businesses, ensuring a greater level of protection in the event of an insolvency. A duty on applicants to remove their registration over a security interest in a timely way would avoid asset financiers using the PPSR as a 'lead generation' vehicle when a business might seek equipment finance in the future.

Recommendation 7. Clarify the treatment of trusts under insolvency law *(ToR item 3)*

Further consideration should be given to reforms regarding the treatment of trusts under insolvency law, in line with the Harmer Report recommendations. The operation of a business within a trust structure provides a high degree of asset protection and commercial benefit, however results in increased complexity and cost of liquidation. Small business operators may also not be fully aware of their obligations when operating under a corporate trust.

On 8 December 2021, we provided a submission to the Treasury consultation on the treatment of trusts under insolvency law (included at **Attachment A**), recommending:

- Where a company is acting as the trustee of a trust and becomes subject to an application for winding up in insolvency, it should not be automatically removed from the trust
- Trustee and trust ABNs should be linked and reported via the Australian Business Registry Service and

[13] Behavioural Economics Team of the Australian Government, *Prompting accuracy: using behavioural insights to support accurate registrations*, March 2022

- ASIC should formulate best practice trustee advice and education guidelines, in collaboration with industry.

Recommendation 8. Review insolvency practitioners' fee structure and responsibilities *(ToR item 5)*

Stakeholders highlighted that, for small business restructuring cases, insolvency practitioners are only paid approximately one-third of what they are paid under a liquidation appointment. Given most of the small business restructuring practitioners are registered liquidators, there is limited financial incentive for them to select small business restructuring appointments over liquidation appointments. Stakeholders also noted that the work involved in a small business restructure is almost as complex and time intensive as in a liquidation, and involves significant personal liability and strict regulatory requirements to adhere to.

The practitioner fees are likewise problematic for small businesses. To appoint a liquidator, businesses reportedly pay upfront fees, commonly in the $16,500-$30,000 range. After getting a director penalty notice, the business has 21 days to either pay the debt in full or enter into an insolvency appointment, which means they have 21 days to find the large sums required. If they do not have the funds, it becomes problematic for them to engage a liquidator.

ASBFEO Case Study 6: Expensive practitioner fees

A small business had entered an insolvency administration with assets worth $1 million. The practitioner had initially advised the small business that the cost to liquidate the companies would be around $60,000. However, half a year later these costs had increased to over $500,000 (over 50% of the value of assets). On top of this, no disbursements had been made until that point.

The small business contacted us for assistance after they expressed their concerns to an insolvency association about the length of time taken and the costs involved. We also wrote to the insolvency association, seeking clarification on the liquidation processes. The association responded that while there were some minor deficiencies in how the practitioner operated, everything was transparent, and no changes were made. There was nothing to be done about the fee increase.

This case study demonstrates the high costs of liquidation and the lack of certainty regarding fees.

The requirement to investigate matters of public good, such as investigation of directors for fraud, may add additional burden on insolvency practitioners. Consideration could be given to only requiring investigations that benefit creditors and result in recoverable assets, while investigations that result in public good could be driven or funded by governments.

The Committee may see value in examining recent academic work that examines the case for a publicly funded small business equivalent to the public trustee, to handle business closures and formal settlement of interests in a business whose resources are inadequate to fund the services of an insolvency practitioner.

We recommend that the Committee undertakes further consultations with insolvency practitioners to better understand their concerns regarding responsibilities and fee structures. Following this, the Committee could consider appropriate incentives to drive increased uptake of small business restructuring appointments. Australian governments already provide grants to support start-up entrepreneurs and expanding businesses, but there are almost no grants to support businesses in distress. The closest such program is the Regional Small Business Support Program, which funds financial counselling and related services for small regional businesses facing hardship due to drought, the 2019-2020 bushfire emergency, 2022 floods or COVID-19.

There could be potential to expand the scope of existing grants or to repurpose them to assist small businesses with fees.

Recommendation 9. Review government agencies' role in insolvency *(ToR item 6)*

We are supportive of the Committee reviewing the role of government agencies in the corporate insolvency system, with a view to improving the engagement experience for small businesses and insolvency practitioners. Through our assistance function, our office is responsible for responding to requests from small and family businesses that are in dispute with other businesses or agencies. After significant discussion with complainants and small business stakeholders, we are aware of a range of concerns with government agencies such as the ATO and ASIC in how they deal with insolvent businesses. This includes concerns that agencies assume deliberate non-compliance by businesses they suspect of tax avoidance. For example, there was a perception among some of our stakeholders that the ATO has a negative bias towards businesses it suspects of tax avoidance, even where there may be proof to the contrary. This perception is contrary to the ATO's approach outlined in the Taxpayers' Charter, to treat clients as being honest by default until proven otherwise. We have previously recommended that the ATO should recognise that small business circumstances can be diverse, and a tailored approach should be taken in all interactions with small business taxpayers to understand their particular circumstances and the reasonableness of demands for information and response timeliness.

Stakeholders raised ASIC's slow or lack of response to acting on insolvency practitioners' reports. They suggested addressing this concern by reducing the extent of practitioners' ordinary reporting to ASIC, while escalating attention to more targeted reporting when a practitioner identifies a prima facie case of unlawful activity or misconduct requiring ASIC investigation. Our office also faces challenges when escalating complaints with ASIC arising from our assistance and dispute resolution services. We recommend our remit be expanded to make us a priority complainant under the *Corporations Act 2001*, empowering us to refer serious complaints to ASIC concerning practices of registered liquidators and office bearers.

Any related corporate insolvency matters

Beyond the scope of this inquiry the Committee may also wish to consider opportunities to best support subcontractors in the construction industry in times of insolvency. The construction industry is regulated by separate state and territory security of payment (SOP) legislation. The lack of a national harmonised SOP law adds to the regulatory burden and discrepancies in treatment in individual jurisdictions.

Thank you for the opportunity to comment. If you would like to discuss this matter further, please contact Ekaterina Grazhdannikova on 5114 6141 or at ekaterina.grazhdannikova@asbfeo.gov.au.

Yours sincerely

The Hon Bruce Billson
Australian Small Business and Family Enterprise Ombudsman

Australian Government

Australian **Small Business** and **Family Enterprise** Ombudsman

8 December 2021

Mr Matthew Bowd
Manager
Market Conduct Division
The Treasury
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Dear Mr Bowd Matthew,

Clarifying the Treatment of Trusts Under Insolvency Law

We welcome the opportunity to comment on the Treasury's discussion paper *Clarifying the treatment of trusts under insolvency law*. Insolvency processes continue to be extremely challenging for small business owners and whilst we are encouraged by recent efforts to increase support and simplify this process a comprehensive review of the insolvency system is required.

The Australian Taxation Office (ATO) has identified that in 2018-19 there were around 314,000 active corporate trustees, with 97% reporting under $5 million of annual turnover. With fewer than 1 million companies in operation in the financial year 2018-19[1] it is clear that the use of the trust structure represents a reasonable proportion of Australian companies.

Through extensive stakeholder consultations we are advised that the operation of a business within a trust structure provides a high degree of asset protection and commercial benefit. However, trusts are complex, technically difficult to manage and costly to liquidate. As such we provide the following comments:

1. **Where a company is acting as the trustee of a trust and becomes subject to an application for winding up in insolvency it should not be automatically removed from the trust.** Most trust deeds automatically remove insolvent trustees, and insolvency practitioners then need to seek court orders to replace the trustee and to liquidate the trust. These legal and court proceedings result in higher and often unnecessary costs that will deplete creditor and beneficiary distributions.

2. **Trustee and trust ABN's to be linked and reported via the Australian Business Registry Service (ABRS).** Currently there is no public record that allows stakeholders to easily identify and link trustees and associated trusts. This lack of transparency can result in significant confusion for trustees, creditors, and liquidators, and creates additional opacity when navigating insolvency.

3. **We recommend ASIC work with industry to formulate best practice trustee advice and education guidelines.** Trust structures are complex and challenging to manage, and small business operators may not be fully aware of their obligations when operating under a corporate trust. To encourage trustee best practice operations, small businesses require

[1] ABS, *Counts of Australian Businesses, including entries and exits,* July 2015 – June 2019

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additional support, with this burden currently falling almost entirely on their trusted advisers. ASIC in conjunction with the professional accounting bodies should seek to formalise best practice trustee advice and education which can then be used by accountants and trustees to assist them in meeting their obligations.

Our Office is acutely aware that not every business will survive their first few years of operation, and established businesses may be liquidated for a range of reasons. However, liquidation processes need to be efficient, effective, and timely to provide businesspeople an affordable and dignified exit.

Thank you for the opportunity to comment. If you would like to discuss this matter further, please contact Mr David Meakin on 02 5114 6106 or at david.meakin@asbfeo.gov.au.

Yours sincerely

The Hon. Bruce Billson
Australian Small Business and Family Enterprise Ombudsman