Australian Government

Australian Small Business and Family Enterprise Ombudsman

Insolvency Practices Inquiry

DISCUSSION PAPER

DECEMBER 2019

Contact
Inquiries regarding this licence and any other use of this document can be directed to:
Manager
Communications and Media
Australian Small Business and Family Enterprise Ombudsman
02 6121 3000
media@asbfeo.gov.au

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The Insolvency Practices Inquiry

Background

In 2016, the Australian Small Business and Family Enterprise Ombudsman released the *Small Business Loans Inquiry* report which explored the impact of external administration on several small businesses. These small business owners felt there was a loss of control and a lack of transparency throughout the process; and with these businesses often being wound up, appeared poorly managed and resulted in less than ideal outcomes both for the owner of the business and its creditors.

On 10 October 2019, we launched the *Insolvency Practices Inquiry* to investigate the experiences of small and family businesses that operate in a corporate structure and have undergone external administration. We are looking at both small businesses that have become insolvent and small businesses whose suppliers or customers have become insolvent. We will work through the events that led up to the insolvency, where the directors sought advice, the choices they were offered and the reasoning behind decisions made. We will determine which processes undertaken were required to comply with the legislation and regulations, and which were at the discretion of the registered liquidator.

To support the inquiry, a Reference Group has been formed from a panel of industry experts, chaired by former Senator John Williams, a member of the Australian Senate for 11 years. The Reference Group acts as a forum for input and discussion on the themes and challenges faced by small or family businesses facing insolvency.

About this Discussion Paper

This discussion paper looks at the framework for corporate insolvencies, key pain points experienced by small businesses – drawn from responses to our survey – and the actions required by registered liquidators under current legislation. We seek feedback on what a best practice framework could look like for both small businesses moving towards insolvency and the professionals that support them during the process.

How to provide feedback

You are invited to respond to the questions posed in this discussion paper by emailing inquiries@asbfeo.gov.au.

Submissions will close on Monday 27 January 2020

For small and family businesses, you can also share your own experience with insolvency through the survey on our website. We would like to hear where turnaround was achieved, where the winding up was done in a collaborative manner and also where the process lacked transparency.

Introduction

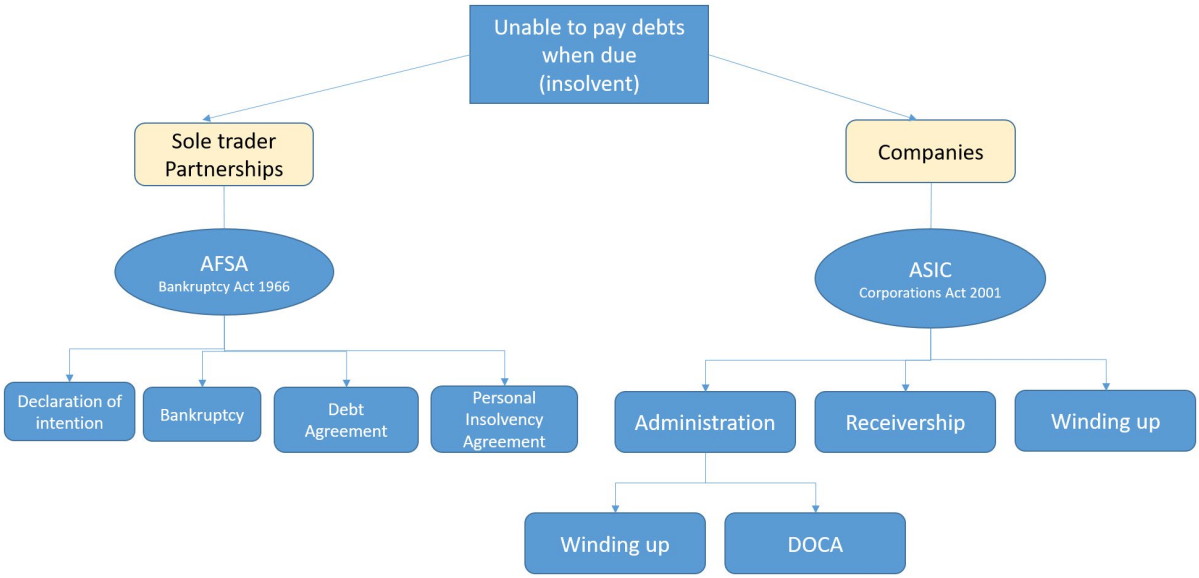
To date more than 300 small businesses have contributed their stories. The overwhelming experience of small businesses has been a loss of control, costs that strip the value of the business and a lack of transparency throughout the process. We have engaged with government regulators, insolvency practitioners (many of whom are small businesses), the professional and industry bodies, lawyers, accountants and financial counsellors.

The key message from the practitioners and other service providers is that small businesses experiencing financial difficulty wait too long before seeking professional advice and assistance. Small business owners ignore the signs of financial distress, hoping or believing that things will improve, until it is too late. Where they do seek help early, the current system appears self-defeating as the costs of a voluntary administration often consume or exceed the assets of the company.

Corporate insolvencies are undertaken by a registered liquidator, governed by the *Corporations Act 2001* and regulated by the Australian Securities and Investments Commission (ASIC). For sole traders facing insolvency, it is a registered trustee, governed by the *Bankruptcy Act 1966* and regulated by the Australian Financial Security Authority (AFSA). Refer to Appendix A for other useful terms.

This paper explores the framework from the experiences of small businesses, identifies which actions had to be undertaken by the registered liquidator and seeks feedback to identify improvements to the framework for the benefit of all parties to the process.

Framework of insolvency:



Questions for comment:

In responding to any or all of the following questions, we welcome your suggestions on what form such changes should take and the risks and benefits of implementation.

1. **At the initial consultation with a registered liquidator, should the registered liquidator be required to provide a small business with:**
    a. **a hard copy plain language fact sheet that outlines the various types of external administration and the role of directors and owners in each?**
    b. **the reasons for recommending a particular course of action to the directors?**

2. **Should there be a control mechanism to prevent the total costs of an external administration from consuming the value of the company's assets? What form could this take?**

3. **Should an information sheet of the average costs for a 'day in court' and the average numbers of court days for particular actions be included with each creditors report?**

4. **In consideration of technology available today, how beneficial would it be to automatically provide the *Annual Administration Return* report lodged with ASIC to creditors, directors, owners?**

5. **Should valuations be provided to, and proposed marketing strategies require approval from, creditors?**

6. **Should demands to recover payments determined to give a creditor an unfair preference in a winding up require the registered liquidator to include the evidence they relied on in making that determination?**

7. **Should it be mandatory for individuals seeking to be directors of companies to undertake core education on running a business and the potential risks of personal exposure to liabilities before being eligible for appointment?**

8. **Should it be mandatory for individuals seeking to start a company or register an ABN to undertake core education on running a business and the potential risks of personal exposure to liabilities?**

9. **Where a small business seeks advice when facing financial difficulties, should the individual proposing a course of action be required to provide the small business with:**
    a. **a hard copy plain language fact sheet that outlines the various types of external administration available and the role of directors and owners in each?**
    b. **the reasons for recommending a particular course of action to the directors?**

10. **How can the safe harbour provision be improved to encourage small businesses to take action early and gain time to assess the viability of the business?**

11. **How can accountants and bookkeepers best support small businesses to seek help early?**

12. **Should increased funding and resources be provided to the financial counselling sector to enable them to provide services to small businesses experiencing financial difficulty?**

13. **Should the impact on the mental health of small business owners and directors be cause for a pause in proceedings?**

14. **Are there other changes that could assist the parties where there are mental health issues?**

15. **General submissions are sought on the fairness of having one system and the benefits and risks of implementing different processes so the costs and time to complete an external administration achieves the optimum outcome for creditors, employees and the company.**

Insolvency system

An insolvent company

A company is a separate legal entity; separate and distinct from its owners (the shareholders) and officeholders (such as directors). In most micro and many small businesses, these are often the same individuals. There is a wide range of more complex business structures, but for our purposes we are talking about a simple proprietary limited company with few officeholders and shareholders. These individuals usually work as company employees and have often advanced funds to the company in the form of loans.

When a company cannot pay what it owes to suppliers, employees and other creditors on time, it is technically 'insolvent'. The directors of a company are obliged to cease trading when it becomes insolvent, otherwise they are committing an offence under the Corporations law.

It is important to realise that the company is the legal structure which conducts a business using assets owned by the company; where the 'business' is sold, it is the assets that are sold. In some circumstances, liabilities or financial obligations are also transferred, but more commonly the outstanding debts remain with the company.

The framework

Australia has a pro-creditor system, that is 'The purpose of liquidation of an insolvent company is to have an independent and suitably qualified person (the liquidator) take control of the company so that its affairs can be wound up in an orderly and fair way **for the benefit of all creditors**.'[1]

Collectively known as external administration, the most common corporate insolvency processes are voluntary administration, liquidation and receivership. During our consultations with ASIC, they advised that across the current appointments of registered liquidators, winding up is by far the majority at over 80%.

While directors may consider a voluntary administration as breathing space to try and find a way to turnaround the company or its business, the function of the registered liquidator in the role of administrator is to:

> *investigate the company's affairs, to report to creditors and to recommend to creditors whether the company should enter into a deed of company arrangement, go into liquidation or be returned to the directors*.[2]

This means that while the registered liquidator will work with the directors of the company to develop a turnaround plan, the course of action the administrator must follow is determined by the creditors.

[1] ASIC, Regulatory resources, Liquidation guide for creditors, 6 December, 2019

[2] ASIC website, https://www.asic.gov.au/regulatory-resources/insolvency/types-of-insolvency/, accessed 15-Dec-19

There can also be more than one registered liquidator appointed to an insolvent company. During a voluntary administration, a secured creditor can appoint a different registered liquidator to recover the specific debt due to them. This process is 'receivership' and the registered liquidator, in the role of receiver or receiver/manager, works for and reports solely to the secured creditor. The receiver will realise sufficient assets to recover the debt to the secured creditor irrespective of the impact on all creditors, the company or the viability of the business as a whole.

External administration and receivership do not automatically lead to winding up. However, the most common experience of small businesses is that once an insolvency process has commenced, the most likely outcome is the winding up and deregistration of the company.

The profession

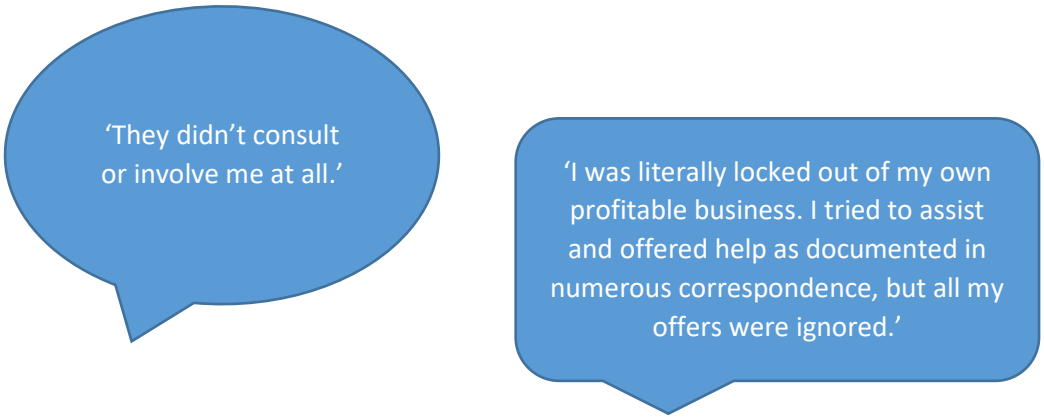
To undertake an external administration or receivership, a person must be a registered liquidator. A person is required to have a base level of qualifications, experience and knowledge and, following an application to ASIC, attend an interview with an expert committee. ASIC maintains the list of registered liquidators, which can be found here.

Registered liquidators can be small businesses themselves and generally sit within a practice with other professionals, such as accountants and lawyers. Registered liquidators take on the liability of the insolvent company they are administering and must personally bear any loss at the completion of an appointment.

In addition to the legislative framework, registered liquidators that are members of the Australian Restructuring Insolvency & Turnaround Association (ARITA) must abide by its Code of Professional Practice (the Code). The Code aims to standardise best practice for all members of ARITA who comprise professionals that have an interest in insolvency, including accountants, lawyers and lenders. The Association of Independent Insolvency Practitioners (AIIP) is exclusively for registered liquidators and provides support and professional development for its members.

Small business experience

Loss of control



When a company enters any form of external administration or has a receiver appointed, the registered liquidator becomes an officer of the company. Their role is to take control of the company's activities, investigate its affairs and report to the company's creditors. There is no obligation to consult with, or keep other officers informed of, the company during the process. Where the small business owners and directors – often the same individuals – are creditors to the company, they will receive the reports and updates provided to all creditors.

Contrary to the experiences shared by small businesses through our online survey, our consultations with registered liquidators indicated that in many circumstances the registered liquidator does engage with the directors of a small business. Where the relationship is collaborative, the registered liquidator is able to investigate the affairs of the company and determine its future direction quickly.

> *'Sought advice in relation to funds owed to clients and specifically how to treat this debt in a sales of business. …engaging a business advisor who specialises in insolvency sector. They then induced me into appointing a voluntary administrator without either advisor or administrator providing accurate advice on consequences, costs and powers of VA.'*

The critical element appears to be the level of detail conveyed to directors seeking help pre-insolvency and who is providing that help. Many of the experiences shared indicate the directors entered voluntary administration in the belief the focus would be on saving the company. When voluntary administration progressed to winding up, apparently with no consultation, directors felt they were being steamrolled and the relationship with the registered liquidator deteriorated. This shows that ultimately, the decision about the future of the company rests with the creditors, not the registered liquidator.

The current legislation reflects the premise that the current management of the company has led to insolvency and an external party must take control to protect the interest of all creditors. The legislation does not allow for financial distress that arises, not from poor management, but from factors outside the control of the directors.

This is supported by the experience of financial counsellors, especially in rural areas of Australia. For small businesses with little profit margin, what may be a temporary or minor disruption to business as usual for a large business can result in the insolvency of a small business. Events can be as diverse as infrastructure works affecting foot traffic for retailers, sudden or long-term illness of key personnel or environmental disasters such as drought, flood and fire.

There is a wealth of information on the internet about how to manage a business, what to do when things get tough, the different types of insolvency and the impact on a company. Yet small business owners, particularly micro business, do not have dedicated administration staff to find this information, in-house accountants to help manage the day-to-day cash flow of the business, or legal experts to interpret the information. When moving towards insolvency, for owners and directors of small businesses, taking time away from running the business is not possible.

ARITA's Code recognises the need for effective communication to address the complexity of insolvency processes and the high emotions surrounding financial loss and loss of livelihood. In seeking ways to bridge the knowledge gap, a balance must be struck between the needs of individuals to be informed and the cost of doing so to the overall cost of the administration.

1. **At the initial consultation with a registered liquidator, should the registered liquidator be required to provide a small business with:**
    a. **a hard copy plain language fact sheet that outlines the various types of external administration and the role of directors and owners in each?**
    b. **the reasons for recommending a particular course of action to the directors?**

Costs

"…prior to their appointment, their total fees estimate was $250,000 and they indicated the administration would take around six weeks. Their fees have totalled over $1 million and continue to increase after two years."

"Costs were outrageous. In writing they quoted $30,000; they charged $260.000."

As the quotes above indicate, small businesses find the costs of an external administration to be unreasonable and drain the limited resources of the company for the benefit of the registered liquidator. To complete even a 'vanilla' voluntary administration, registered liquidators advise that it can cost between $40,000 to $60,000. This is higher than the value of assets in the majority of insolvencies. Statistics from ASIC show that since 2004 over half of the insolvencies had total estimated assets of less than $50,000; for 2017/2018 it was 78% of all insolvencies.

At the start of external administration, small business owners have their perception of the value of assets and know the total of debts due to creditors. This sets their expectation for the value that should be left in the company once all debts are paid. Without transparency over the process, they are left with no company and no business, even though creditors may have only received partial payment against the debt that was due. Often small businesses feel their assets were sold for less than market value and that the registered liquidator charged excessive fees.

At the time of their appointment, registered liquidators highlight that they are not and cannot be aware of the true financial position of a company. Only once an investigation begins will they be able to determine the potential value of assets and total liabilities of the business. As a registered liquidator must complete an appointment once accepted, where there are no or limited assets, they will not recover their costs.

While there is no cap on the costs that may be incurred, the registered liquidator's remuneration or fees are only part of the total cost. The current legislative framework sets out the various processes that registered liquidators must undertake in the different types of appointments, including the types of expenses that can be incurred, which ones need approval prior to incurring and how they are to be reimbursed. The total cost of an external administration is comprised of remuneration, internal disbursements and external disbursements. Remuneration and internal disbursements must be approved by creditors prior to being paid. External disbursements do not require approval and are reimbursed to the registered liquidator at cost.

Estimates of the remuneration and fees charged by the liquidator and their staff to undertake the external administration must be approved by creditors. Generally, approval will also be sought for a capped value for internal disbursements. At subsequent approval requests, the registered liquidator will report against these estimates and seek approval for the next drawdown.

Example of a remuneration claim:

Employee	Position	Hourly Rate	Total Hours	Total $
Joe Public	Partner	750	7.75	$ 5,812.50
Josie Public	Partner	750	28.6	$ 21,450.00
Fred Smith	Senior manager	500	1.2	$ 600.00
Freda Smith	Associate	275	3.62	$ 995.50
Joe Smith	Admin	120	5.4	$ 648.00
Total			**46.57**	**$ 29,506.00**
GST				$ 2,950.00
Total (incl. GST)				**$ 32,456.00**
Average hourly rate (before GST)				$ 633.58

Example of internal disbursements incurred:

Internal Disbursements		
Facsimile	10 pages @ $2.00/page	$ 20.00
Photocopying	1,100 pages @ $0.75/page	$ 750.00
printing	986 pages @ $0.75/page	$ 739.50
Telephone	652 minutes @ $1.12/min	$ 730.24
Total		**$ 2,239.74**
GST		$ 224.00
Total (incl. GST)		**$ 2,463.74**

External disbursements are categorised into non-professional fees and professional services. Non-professional fees include costs such as travel, accommodation, search fees and the costs to run the business, such as council rates. Professional services include the costs to engage other professionals, such as surveyors, valuers and legal practitioners.

Example of external disbursements:

External Disbursements		
Surveying fees	at cost	$ 1,200.00
ASIC notice publication fees	at cost	$ 30.00
Council rates	at cost	$ 1,860.25
Travel expenses	at cost	$ 87.20
Court filing & other fees	at cost	$ 1,426.00
Total		**$ 4,603.45**
GST		$ 224.00
Total (incl. GST)		**$ 4,827.45**

External disbursements are difficult to estimate. A registered liquidator cannot know from the outset how the administration will progress and what issues or conflicts will arise. It raises the question if creditors can be fully informed when they vote on the course of action to be taken by the registered liquidator.

For example, registered liquidators may seek creditors' approval to recall payments made by the insolvent company in the six months prior to the company being placed in to external administration; voidable preference payments. Yet, if creditors were aware that to defend such demands may end up in a court incurring significant costs and time, they may instead vote to wind up the company and receive a lower, but known, distribution.

Where any such actions of the registered liquidator are challenged, the costs escalate exponentially and the timeframe to resolve can extend into years as matters must be dealt with through the courts. In small external administrations, there is rarely sufficient funds to defend claims through the courts. In these administrations, the registered liquidator will be out of pocket as they must pay for their legal representatives and court fees as they are incurred.

> *'A father and son agreed to a voluntary administration. On commencement, costs were estimated to be $70,000. The first creditors meeting included a proposal for an increase in Administrators fees from $70,000 to $280,000. To date, the Administrators have been paid approximately $700,000 in professional fees plus disbursements.'*

There is a concern that the lack of transparency on, and the right to claim back at cost, external disbursements provides an incentive for some registered liquidators to over-service an external administration. For example, we have heard of cases where five representatives from the registered liquidator's office attended a court hearing yet only two actively participated. In another case, a registered liquidator and two staff travelled interstate to review a business operation, without making an appointment with the owner. The owner was not at the premises when they arrived and they had to repeat the exercise.

All payments and receipts, including external disbursements, are reported by registered liquidators to ASIC annually during, and on completion of, an external administration. Changes effected in 2017 removed the requirement to provide an annual report to creditors. This reflected the finding that creditors are not interested in annual reports so the cost to produce them is unwarranted.

2. **Should there be a control mechanism to prevent the total costs of an external administration from consuming the value of the company's assets? What form could this take?**

3. **Should an information sheet of the average costs for a 'day in court' and the average numbers of court days for particular actions, be included with each creditors report?**

4. **In consideration of technology available today, how beneficial would it be to automatically provide the *Annual Administration Return* report lodged with ASIC to creditors, directors, owners?**

Lack of transparency

> *'A small business director was travelling overseas when a creditor lodged an application for winding up of the company. A liquidator was appointed and the directors could not afford legal representation to challenge the appointment, nor the liquidator's subsequent actions. This led to personal bankruptcy.'*

A lack of transparency has been cited, most often, in cases of receivership. As the receiver is appointed by, and works exclusively for, a secured creditor there will be no transparency for other parties dealing with the company. While the receiver must complete the statutory reporting to ASIC, there is no obligation to report to any other party other than the secured creditor. The directors of the company are required to provide various documents and reports to the receiver on request, but are not advised of the actions the receiver intends to take to realise assets.

Where directors of an insolvent company are not creditors, in any form of external administration, directors will be in a similar position as registered liquidators report to the creditors of a company, not the officer bearers of a company. Some registered liquidators will provide a link on their website that allows parties to an insolvency to access all reports filed. Creditors also have the right to request information directly from the external administrator, though very few appear to do so. Some reports lodged by registered liquidators are available on request to, and accessible through ASIC Connect, the portal to search company and other registers, for a fee.

To access information through ASIC Connect you will need to know the company's legal name or ACN/ABN and the specific form that holds the desired information. An outline of the forms required to be lodged by external administrators and the information contained can be found in the flowcharts on ASIC's website[3].

Extract from ASIC Connect: Company search for 'Harris Scarfe Limited', under documents:

Documents Show all documents

Last 3 Documents Lodged

Date	Document No.	Document type	Pages	Uncertified	Certified
11/11/2019	7EAR16886	(5603)	6	$17.00 ☐	$36.00 ☐
11/10/2019	7EAQ20726	(505)	2	$17.00 ☐	$36.00 ☐
24/06/2019	7EAM57684	Annual Administration Return Return of Winding Up By Court (5602B)	5	$17.00 ☐	$36.00 ☐

[3] https://asic.gov.au/for-finance-professionals/registered-liquidators/your-ongoing-obligations-as-a-registered-liquidator/external-administration-controller-appointments-and-schemes-of-arrangement-most-commonly-lodged-forms/

While a lack of transparency may be experienced throughout the entire insolvency process, the activity most consistently raised by small business is the valuation and marketing of the business and its assets. The legislation relies on market forces to achieve best price. As the use of a valuer and sale agent would be categorised under external disbursements, even creditors are unaware of the valuation and sale process.

Micro and small businesses can also be blindsided when a customer becomes insolvent. The first they may know of an issue is on receipt of a demand to return a payment received in the normal course of business. As a supplier you can refuse to meet the demand by proving that the payment was not in excess of the amount owed by your customer. In issuing a demand to return a voidable preference payment, a registered liquidator has no obligation to consider the capability of the company receiving the demand to return these funds.

This appears particularly unfair when a small business has been diligent in chasing up payment for its invoices, only to receive a demand to return payments to the amount available to distribute to all creditors – irrespective of the business practices of the other creditors. While a demand can be refused, it may be subsequently challenged by a registered liquidator through the courts. Small businesses struggle to afford legal advice and cannot afford to seek resolution through the courts.

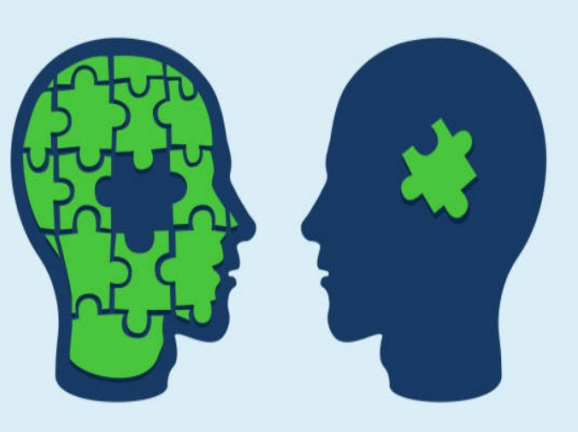
5. **Should valuations be provided to, and proposed marketing strategies require approval from, creditors?**

6. **Should demands to recover payments determined to give a creditor an unfair preference in a winding up require the registered liquidator to include the evidence they relied on in making that determination?**

Education of directors

Owners and directors of small businesses will likely need to deal with insolvency at some point in their commercial lives, and without legal expertise, they are necessarily required to navigate a highly complex legislative framework.

This illustrates the first hurdle for a small business moving towards insolvency, or becoming aware that supplier or customer is insolvent; to gain an understanding of their rights and options. What information will be provided, what information they have the right to request – and from where - and what actions they can challenge.



As small business owners do not have legal departments and are rarely legal experts in their own right, they rely on the person providing them with advice.

As we have consistently heard, the imbalance of knowledge is particularly evident in the mismatch of the small business owners' expectation of turnaround and the reality of the financial state of their business. Financial counsellors observe that small business owners often deny the extent of their financial trouble until a 'red letter' day; that is, a notice of intention to disconnect utilities or an eviction notice from the landlord. Small business owners hope that trading conditions will improve and they avoid admitting to themselves, family and close associates that the business is in financial difficulty.

Clearly, it is better that a small business or family enterprise avoids insolvency in the first place. While there is significant information available from a variety of resources, the number of companies entering external administration remains consistent, between 8,000 – 9,000 a year. Many inquiries and reports have considered if some form of preparatory instruction should be mandatory as part of applying for an ACN or ABN. The concern has been the potential to stifle innovation. Consideration must be given to the impact on individuals when more than 20% of businesses employing less than 20 employees fail to survive more than one year[4].

7. **Should it be mandatory for individuals seeking to be directors of companies to undertake core education on running a business and the potential risks of personal exposure before being eligible for appointment?**

8. **Should it be mandatory for individuals seeking to start a company or register an ABN to undertake core education on running a business and the potential risks of personal exposure to business?**

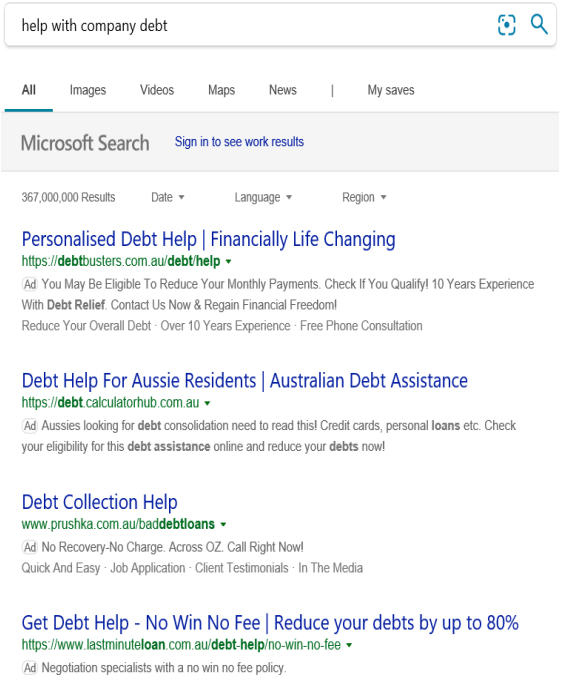
Turnaround options

[4] ABS Catalogue BNo. 8165 0 Counts of Australian Business

'I researched options and a company named [debt solvers] was approached to see what they could do. After advice was received we accepted their offer to help. Two days later we found they were owned by a receiver [legal firm] and the company was advised to temporarily go into voluntary administration.'

Small business owners, in particular micro businesses, have little time available to step out of the day-to-day running of the business and work on the future of the business. As we have heard, the key issue is getting help early. Yet often, to avoid incurring more costs, in place of reaching out to their bookkeeper or accountant, the first port of call is the internet.

The top searches reveal those organisations that invest in marketing, Google ad words and search engine optimisation and are commonly referred to as pre-insolvency advisers. The word adviser can be misleading as there are no requirements to be licenced, no regulation of their practises and no dispute resolution process if things go wrong. Often this initial meeting is a discussion, with no written record of strategies recommended.



Recently the Government introduced the safe harbour provision with the intent to allow a business to pause, assess its viability and build a turnaround plan. While this appears a real alternative for large firms, as small businesses often seek help only after significant debt has accrued, including tax and employee entitlements, they cannot access the safe harbour provision. If they can, the cost of developing a plan can be outside the reach of the small business resources.

Most small businesses utilise the services of an accountant just once a year, associated with the income tax return. Accountants and bookkeepers are important since they are trusted advisers and can educate directors on how to interpret the financial health of the business and how to identify the factors that place the financial health at risk.

9. **Where a small business seeks advice when facing financial difficulties, should the individual proposing a course of action be required to provide the small business with:**
    a. **a hard copy plain language fact sheet that outlines the various types of external administration available and the role of directors and owners in each?**
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12. **Should increased funding and resources be provided to the financial counselling sector to enable them to provide services to small businesses experiencing financial difficulty?**

Mental health

'For the first time in my life, I was driven to contemplate suicide. If I did not have two beautiful young children who were totally dependent on me, and me alone, I would not have been alive today. It has been a living hell and still is, for me and my family.'

What we have heard is that the stress and feelings of loss of control during an external administration can have a profound and enduring effect on the mental health and wellbeing of the small business owner.

There is a need for recognition of the particular stresses on small business directors when a company is placed in external administration. In many cases, the family home has been secured to support funding for the business and lenders follow processes to liquidate the asset. And if there is still a shortfall, bankrupt the individuals, in their capacity as guarantors of the business debt.

These consequences are more damaging than just a company failing and the shareholders losing their capital investment. The protection of a 'proprietary limited' company structure is less reliable for micro and small businesses who, by necessity, have involved personal assets with company financial arrangements.

The joint initiative of ARITA, AFSA and ASIC to implement the *Insolvency Mental Health Awareness Program* (IMHAP) is a significant first step to help insolvency professionals better engage with people experiencing financial distress. The Australian Taxation Office recognises the impact of stress and mental health difficulties for small businesses and encourages them to be in contact early to maximise the options for assistance.

Our own office recognises the importance of good mental health for small business owners and recently launched the co-sponsored *My Business Health* portal which provides guidance, resources and links to specialist support services.

Unfortunately, none of these initiatives allow a pause in an external administration process. The very act of finally facing the reality that the business you have poured everything into is in peril will cause significant stress. Realising the impact on family, friends, customers and suppliers – often small business themselves – can lead to broken relationships and mental breakdowns.

13. **Should the impact on the mental health of small business owners and directors be cause for a pause in proceedings?**

14. **Are there other changes that could assist the parties where there are mental health issues?**

One size fits all

The current framework requires registered liquidators to meet the same core requirements whether the insolvent company has assets of $5 million, $500,000, $50,000 or $5, or has a hundred or more employees or one employee.

For consideration, at Appendix D are examples of processes in place in other jurisdictions. Below are those that have been raised during our consultations.

Financial health check

Consider for small businesses, the provision of a confidential concierge service for a fixed fee to access advice from an expert to review the business operations. The review would identify activities that are causing financial stress and make recommendations to improve operations. Where the review concludes the business is not viable, it would recommend the optimal external administration process.

Benefits include time to review and correct, potential to maximise value if the business should be sold without the impact of the appointment of a registered liquidator, and preservation of the value of assets as well as the business' 'brand' (no bad publicity etc.).

Pre-packs

Consider implementing the pre-pack option available in other jurisdictions such as the United Kingdom. Benefits include the business can be sold without impact to operations caused by the appointment of a registered liquidator, and preservation of the value of assets as well as the business' 'brand' (no bad publicity etc.). However, there are disadvantages, such as perceived secrecy and abuse of system.[5]

Particulars	Pre-pack sale	Insolvency sale
All employees transferred to new company	92%	65%
Secured creditor return	42%	28%
Average return (unsecured creditors)	1%	3%
Sale of assets to related party	59%	52%

Short form process for companies under a threshold

Consider a two tiered system based on a threshold. Statistics on insolvencies show that over half of all insolvencies had total estimated assets of less than $50,000 and the majority concerned companies with less than 20 employees.

15. General submissions are sought on the fairness of having one system and the benefits and risks of implementing different processes, so the costs and time to complete an external administration achieves the optimum outcome for creditors, employees and the company.

[5] Frisby SA "Preliminary analysis of pre-packed administrations" 2007 *https://www.r3.org.uk* (follow the Publications link).

Appendix A: Useful terms

External administration:

- Liquidator / Administrator / External Administrator
  - The individual(s) managing an external administration
  - They must be a registered liquidator to be appointed to any role in the company (other than receiver/controller)
  - They can act as administrator or liquidator.
- Appointment
  - The process, or type of external administration
  - NB: not the qualification of the person managing the process.
- Receivership
  - A secured creditor appoints a receiver to manage the company or property
  - A receiver will collect and sell enough of the assets over which the creditor holds security to repay the debt due
  - They act for the secured creditor only
- Personal Property Security Register
  - Where a creditor registers their right, security, over personal property of an individual or company
  - Click on this link for more information
- Voluntary Administration
  - Directors or a secured creditor appoint an administrator to manage the company
  - The administrator will investigate the company's affairs and recommend next steps to the creditors of the company
  - Can result in a deed of company arrangement, winding up or the business being returned to the directors
- Deed of company arrangement
  - A binding agreement between the company and its creditors on how the company will be dealt with
- Liquidation or a winding up
  - The selling of the company's assets to distribute net proceeds to the creditors
  - Members' voluntary – started by the directors when the company is solvent and an orderly winding up is sought. Assets are sold and creditors paid, and the surplus distributed to shareholders
  - Creditors voluntary – started by the directors when there are not enough assets to pay all debts; the intent is to liquidate the company's assets and distribute the proceeds as a partial return to creditors
  - Court – started by a creditor of the company by application through the court

Bankruptcy

- Declaration of Intention to present a Debtor's Petition
    - A declaration of intent to consider your next steps
    - It provides 21 days when unsecured creditors cannot take action
- Debtor's petition
    - Voluntary application for bankruptcy
    - Lodged with the Official Receiver together with a Statement of Affairs
    - May be lodged with consent from a registered trustee, or otherwise will involve the appointment of the (government) Official Trustee
- Creditor's petition
    - A request by someone you owe money to (creditor) to have you made bankrupt
    - The creditor must present their petition to a court
- Debt agreement: known as Part IX (9)
    - A legally binding agreement with your creditors to settle the debt
    - for example, can allow you to make repayments over time
- Personal insolvency agreement: known as Part X (10)
    - A proposal to settle debts which creditors vote on in a formal meeting
    - A trustee is appointed and they will convene a meeting of creditors to consider an offer from a debtor to avoid bankruptcy
- Trustee in Bankruptcy
    - The person or entity who manages your bankruptcy

Appendix B: Terms of Reference

INSOLVENCY PRACTICES INQUIRY

Terms of Reference

Purpose

The Australian Small Business and Family Enterprise Ombudsman will undertake an inquiry into the insolvency system to establish if it encourages practitioners, in the first instance, to restructure the small or family business to turn it around when facing financial difficulties. Where a restructure is not possible, we will investigate if current insolvency practices achieve the best outcome for all parties.

The inquiry will examine:

- the existing insolvency system through the experience of small businesses, in particular, where they may be able to contribute to the process
- the degree of transparency of the governance, processes and costs of practitioners including legal experts, valuers, investigating accountants, administrators, receivers and liquidators
- how the insolvency of a small or family business may lead to bankruptcy for the owners
- how the established framework impacts the practices and fees of insolvency practitioners.

Our *Small Business Loans Inquiry* identified a lack of transparency for the small business owner when a creditor commenced debt recovery action. The small business owners felt they had lost control of their business as they were unable to contribute to, or obtain copies of, reports by insolvency practitioners. As the cases reviewed frequently ended in the business being wound up, the process appeared poorly managed to the small business owners and resulted in less than ideal outcomes for the owner, the lender and creditors of the business.

We will identify areas where practices can be improved and recommend changes to the system to achieve fairer outcomes for all parties involved.

Scope

The inquiry will examine:

- the legislation, compliance and industry standards that govern insolvency practices and practitioners
- the different outcomes depending on who initiates the action including the small business owner, a creditor by application through the courts or a secured creditor through receivership
- the transparency, timeframes and costs across the different insolvency actions
- how conflicts of interest, arising from the same practitioner undertaking several stages of an insolvency, are managed
- how practitioners decide the optimal process to maximise the return for creditors
    - where winding up is delayed - ensuring the necessary expertise is engaged to manage the business to maximise the value of the assets at a future point in time

    - where the value of assets is to be realised immediately – what factors are taken into consideration to determine the target market and marketing campaign.

Reviews and consultations:

- Small and family businesses – seek case studies of experience of insolvency
- Australian Securities & Investments Commission, Australian Financial Security Authority and the Treasury – legislative framework and fees
- Courts – their role in the insolvency process Consultants to, and funders of, actions in insolvency
- Industry associations – monitoring and compliance to codes of practice
- Practitioners – roles, responsibilities, compliance costs, fees charged
- Practitioners in regional and remote locations – impact of geographical location.

Reference Group

The Reference Group will act as a forum for input and discussion on the themes and challenges faced by small or family businesses facing insolvency.

Former Senator John Williams, who was a driving force behind the Senate Economics References Committee inquiry in 2010 into the regulation, registration and remuneration of liquidators, will Chair the group.

Outcome

We will propose initiatives to help small businesses facing financial difficulties, better inform small businesses on how to navigate insolvency and increase the transparency of the actions taken by insolvency practitioners. We will also identify specific activities or areas within the insolvency process that warrant further investigation.

Timeframe

Commencement: 10 October 2019
Interim report: 11 December 2019
Final report: 18 February 2020

Appendix C: Survey Questions

This survey is to collect experiences from small and family businesses that have faced financial difficulties and restructured or wound up the business. The cases provided will help identify, and form recommendations to address, the challenges faced by small and family businesses facing insolvency. It is important that you do not provide information in your outline that may breach a confidentiality agreement.

The survey should take approximately 10 minutes to complete. We ask broad questions about your business and provide a text box for your outline.

About your business (mandatory):

1. Located in which state or territory?
2. Metropolitan or regional centre?
3. Which industry sector(s)?

About your experience:

4. Please outline your experience.

Would you like to provide feedback on specific issues?

The following questions are optional, please complete if relevant.

5. Who started the insolvency process?
6. Was restructure considered?
7. How much were you involved in the process?
8. Did you believe the sale process achieved the best possible outcome?
9. Would you consider the time and cost reasonable?
10. Did you seek, and who from, advice?

If you are willing for your case to be referred to in our report, please provide your contact details

If you choose to participate:

- You must not provide information that would be in breach of a confidentiality agreement
- The information provided to the inquiry is not covered by parliamentary privilege

Importantly, the Ombudsman cannot change the outcome of your issue, fund or intervene in legal actions or get you compensation

Close

Thank you for taking the time to complete this survey.

Appendix D: International comparisons

Many pro-creditor jurisdictions are working towards establishing more protections for debtors. It is possible to learn from the procedures in other countries to help inform the current processes in Australia and identify future possible directions.

In the United Kingdom pre-packs have been used for approximately 15 years with the vast majority used by companies that have under $100,000 in assets.[6] It is a method where the sale of all or part of a business and its assets are arranged before entering formal insolvency, with the sale being executed as soon as an administrator is appointed. This results in lower costs associated with getting a business out of insolvency, being about 50% cheaper than a formal voluntary administration process. They also have a 96% success rate of preserving existing employee jobs.[7] Pre-packs are also used in Belgium, Czech Republic, France, Germany, Italy and the Netherlands.

The French insolvency process is aimed at the rehabilitation of a business. It has a simplified procedure, designed to be faster, for small businesses with less than 50 employees and annual turnover under €3m (approx. $5m AUD). If a small business is in financial trouble, it can enter into 'safeguard proceedings'. This involves some combination of restructuring, recapitalisation of the company, debt for equity swaps, sale of assets and partial sale of the business. If the small business becomes insolvent, it can develop a rehabilitation plan to attempt to save the business and enter into a conciliation procedure. Conciliation can allow for a contractual agreement to be reached between the debtor and creditors to defer repayments or reduce the amount due. Most notably, conciliation can be undertaken privately which allows the small business to maintain their credibility and avoid stigma.

The Russian insolvency system includes procedures aimed at the business regaining solvency, but there is no special preference given to either creditors or debtors. Tools include insolvency prevention actions, financial recovery, external administration and settlement agreements. The Russian federal insolvency law states that insolvencies in some industries/areas may be harmful for their industries and economy, therefore the government seeks to help them stay in business.

In the United States of America, Chapter 11 provisions as part of their bankruptcy system allows a business time to restructure their debts. A bankruptcy court has control over major decisions like the sale of assets, entering into or breaking a lease, secured financing arrangements, and shutting down or expanding business operations. A reorganisation plan must be developed that includes the downsizing of the business to reduce expenses, and renegotiation of debts. Individuals can file under Chapter 11 if they have too much debt or income to qualify under Chapters 7 and 13. There is no limit on the duration of Chapter 11 cases but they usually go for six months to two years. Reports state that 10-15% of Chapter 11 cases result in successful reorganisations.[8]

[6] https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration
[7] ibid
[8] https://www.nolo.com/legal-encyclopedia/chapter-11-bankruptcy-overview.html