Regulation Impact Statement – Insolvency reforms to support small business

Background

Recent evaluations of the Australian corporate insolvency framework, including by the Productivity Commission in 2015[1], have confirmed that it performs well on most fundamental indicators, including the time taken during an insolvency process, the proportion of funds recovered, creditor participation and the management of debtor assets.

But significant issues with the framework have still been identified. One issue that has been raised consistently – by government agencies, stakeholder groups and international bodies – is the failure of the Australian system to account for the needs and characteristics of different size businesses during insolvency, particularly small business.

In corporate insolvency, Australia has a one-size-fits-all system, which simultaneously must account for the needs of all business types. In practice, this means that key components of our laws have been designed to respond to the complexity of a large corporation. The Australian Restructuring Insolvency and Turnaround Association (ARITA) has previously advocated for the need to streamline the current insolvency processes for small businesses. In 2020, the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) in its *Insolvency Inquiry Report* also recommended the Government adopt streamlined insolvency processes for small businesses and argued the current regime was not working for small businesses.[2] The ASBFEO stated:

> Small business owners report facing an opaque system, where decisions are taken out of their hands, they feel pushed into outcomes they were not looking for, and their expertise or knowledge of the business they have been running is discounted or ignored.

International organisations have also recognised the issues posed by a one size fits all approach. The Organisation for Economic Co-operation and Development (OECD), for example, found in its Going for Growth report[3] that:

> Small and medium enterprises (SMEs) may warrant a different treatment from other firms in a debt restructuring strategy as complex, lengthy and rigid procedures, as well as required expertise and high costs of insolvency can fail to adequately meet the needs of SMEs.
>
> Special insolvency procedures for SMEs… could ensure that non-viable ones exit and viable ones in temporary distress are restructured without delay.

As a part of the Government's response to COVID-19 temporary relief for financially distressed businesses was introduced through the *Coronavirus Economic Response Package Omnibus Act 2020* which received Royal Assent on 24 March 2020. The relief increased the minimum threshold for creditors issuing a statutory demand from $2,000 to $20,000 and increased the time to respond to the statutory demand from 21 days to six months. Directors were also given temporary relief from personal liability if a company trades while insolvent. The Treasurer was also granted instrument-making power to make temporary amendments to the *Corporations Act 2001* (the Corporations Act). These temporary changes were scheduled to apply for 6 months, from 25 March 2020 until 24 September 2020. On 7 September 2020, the Treasurer announced that the temporary insolvency measures would be extended until 31 December 2020.

The removal of the temporary insolvency protections will have an impact on the number of companies entering external administration due to the effectiveness of measures in keeping firms

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[1] Productivity Commission 2015, 'Business Set-up, Transfer and Closure: Productivity Commission Inquiry Report', https://www.pc.gov.au/inquiries/completed/business/report/business.pdf

[2] ASBFEO 2020, Insolvency Practices Inquiry: Final Report https://www.asbfeo.gov.au/sites/default/files/Insolvency%20Inquiry%20Final%20Report.pdf

[3] OECD 2018, 'Going for Growth', p.97, http://www.oecd.org/economy/growth/policies-for-productivity-the-design-of-insolvency-regimes-across-countries-2018-going-for-growth.pdf

out of external administration due to the impacts of COVID-19. This risks a 'wave' of external administrations occurring in the lead up to and immediately following the winding back of temporary support measures. From April to September 2020, there was a decrease in companies entering external administration of 51.2 per cent compared to the same period in 2019 (a decrease from 4,404 to 2,139). Extrapolating this rate to the end of the year results in approximately 3,000 companies that have not entered external administration compared to the corresponding period last year.

Following the implementation of the temporary insolvency measures, Treasury undertook consultation with stakeholders to gauge their impact and effectiveness, and test the case for any further government action. Treasury held regular meetings with stakeholders including ARITA, the Turnaround Management Association (TMA), and other stakeholder groups. These meetings helped Treasury to understand the impact of the temporary measures and the broader effectiveness of the current insolvency framework in light of the impact of COVID-19. Treasury also met with the ASBFEO to discuss the findings of its insolvency practices inquiry in the context of COVID.

In these consultations stakeholders also repeated concerns on the need for a small business regime, and argued that the pressures that COVID-19 has placed on business and the insolvency sector have made the case for permanent reform of the insolvency framework more urgent.

The lack of technological neutrality surrounding the external administration provisions of the Corporations Act has also been a concern for industry due to the resulting regulatory burden. This includes requirements to provide notice documents in hard copy by post, and to hold meetings in physical locations (even if participants would prefer to attend virtually).

On 6 May 2020, the Treasurer made a determination under the temporary instrument-making power that was inserted in the Corporations Act as part of the Government's Coronavirus economic response package. The determination provides temporary relief by allowing companies and insolvency practitioners to virtually or electronically satisfy requirements related to their legal obligations concerning meetings and document execution. This supported them to continue operating while still meeting social distancing requirements imposed as a result of the continuing uncertainty caused by COVID-19.

The temporary relief has also provided an opportunity to test with stakeholders how making these requirements technologically neutral operates in practice to deliver options for companies to meet their obligations under the Corporations Act. This has provided an opportunity to test the reforms and receive feedback on the lived-experience from stakeholders, companies and insolvency practitioners, on how the relief has been operating in practice.

1. What is the policy problem you are trying to solve?

Importance of an insolvency system

An efficient and effective insolvency system is important in generating business dynamism, which is needed to underpin our economic recovery. The system helps the movement of capital and jobs to more productive from less productive firms. It allows the efficient winding up of businesses, ensuring creditors and employees are paid fairly.

Insolvency affects a large number of businesses, with ASIC data showing that 8,105 companies entered external administration[4] in 2018-19.[5] Behind these companies sit a larger number of

[4] A term used to describe one of the formal insolvency processes.

[5] ASIC 2020, Australian insolvency statistics, https://download.asic.gov.au/media/5841015/asic-insolvency-statistics-series-2-published-november-2020.pdf

affected creditors, business owners and employees. Of these 8,105 companies, only 1,226 entered voluntary administration. The pool of practitioners to manage these external administrations is also comparatively small: there were only 648 Registered Liquidators in 2018-19.

The effectiveness and efficiency of our insolvency system is very important for small businesses. Most of the companies which interact with the insolvency system are small businesses. According to ASIC data, around 76 per cent of companies entering into external administration in 2018-19 had less than $1 million in liabilities. Of these, around 98 per cent are estimated to be businesses with less than 20 full-time equivalent employees.[6]

Issues with Australia's insolvency framework

Australia's insolvency framework is failing to fully accommodate the needs of Australian small businesses. The issues include:

- The need to ensure that regulatory obligations are commensurate with the complexity of the business and the likelihood of misconduct.
- The need to maximise the opportunity for distressed but viable companies to restructure and survive.
- The need to maximise returns for creditors in the event that a business is wound up.

Currently, Australian businesses can only access insolvency processes that are the same no matter the size of the business. As outlined below, the current processes are better suited to larger, more complex company failure, which may have greater means to engage in sophisticated forms of misconduct.

However, most companies engaging with these processes are smaller companies who overwhelmingly fail 'honestly'. In these cases, the current requirements are not proportionate to the size and complexity of the company, and to the assets or liabilities that they hold. As ASIC, in its submission to the 2015 Productivity Commission review on Business Set-up, Transfer and Closure[7], stated:

> Current insolvency laws take a, 'one size fits all' approach; with the same duties and obligations imposed on the external administrator [a broad category of insolvency practitioner, including liquidators] regardless of the size and complexity of the external administration.
>
> Industry has argued that the cost of administering small- to medium- size enterprises is high and often the external administrator is required by current law to undertake tasks (investigations and reporting to creditors and ASIC) in circumstances where there are insufficient assets to pay the costs of this work.

This state of affairs has significant repercussions for Australian businesses, especially small business:

- It imposes costs across all parties involved in dealing with an insolvent business. In most cases, businesses are required to enter an insolvency process once they become insolvent. Inefficiencies in the insolvency processes mean reduced returns for creditors, and less money to reinvest in other activities.

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[6] ASIC 2020, Australian insolvency statistics

[7] ASIC 2015, Productivity Commission: Review of Barriers to Business Entries and Exits in the Australian Economy, p. 39, https://www.aph.gov.au/DocumentStore.ashx?id=011ea16b-b0f5-4a57-8c5a-7a26b40acbb8&subId=401940

- High costs, complexity and other factors can discourage businesses, especially small businesses, from entering into insolvency processes early when they have more chance at successful restructure, or more assets to distribute to creditors.

Facilitating restructure

Organisations including the OECD have stated that the first priority of an insolvency system should be to enable companies that are distressed but ultimately viable to restructure.[8] Doing so allows the company to continue to compete in the market in a more efficient form, preserving business value and employee linkages.

Despite this, there are significant limitations to voluntary administration, the main formal insolvency process aimed at enabling insolvent companies to restructure:

- Voluntary administration tends to be a high-cost process. It requires an administrator to take on liability for debts incurred by the company, which the administrator must indemnify themselves against.
- It provides very broad powers to the administrator, who take on the running of the company during voluntary administration. In turn, this means more rigorous registration requirements must be applied for administrators which reflect the complexity of the process.
- It requires an external administrator to take over the running of a company and the risks of trading (subject to an indemnity), which may discourage use of the process and the continued trading of the business when it is used.

These factors may limit the usefulness of voluntary administration for small businesses especially. For small businesses, the high costs of voluntary administration can also consume most or all of the value of a small business's assets, making successful restructure difficult. The powers and expertise of an administrator for a large firm may not be in line with the needs of a distressed small business (who may simply need an avenue to pay down an outstanding debt). Small and family businesses may be especially reluctant to call in an external administrator to take over the running of a company, reducing the opportunity for a company to restructure early when it is more likely to be viable.

Stakeholders have proposed alternative policies to address the limitations of voluntary administration as a small business restructuring tool. For example, ARITA in 2015 proposed a simplified debt restructuring process for 'micro' companies[9]. The OECD also encouraged Australia to adopt a debt restructuring strategy for SMEs which applied different treatment for smaller firms, with the intent of reducing the barriers associated with "complex, lengthy and rigid procedures, as well as required expertise and high costs."[10]

Liquidation

The current requirements imposed during a liquidation can require a stringent process which can be lengthy and expensive. Many of the current requirements imposed are aimed at detecting and addressing any misconduct that might have occurred in the lead up to insolvency. These include investigative requirements (behaviour that the insolvency practitioner must look for), requirements

[8] OECD 2018, 'Going for Growth', p.91.

[9] ARITA 2015, Submission to Productivity Commission review on Business Set-up, Transfer and Closure, p. 15 https://www.arita.com.au/documents/pc-submission-020315-website.pdf

[10] OECD 2018, 'Going for Growth', p.97, http://www.oecd.org/economy/growth/policies-for-productivity-the-design-of-insolvency-regimes-across-countries-2018-going-for-growth.pdf

to call meetings (to seek creditor views and input on aspects of the process) and reporting functions (particularly to ASIC). Consequently, according to industry, even non-complex liquidations can take up to a year to complete.[11]

While these requirements are appropriate for larger, more complex firms, the current requirements do not consider the needs of small business and the circumstances surrounding most small business insolvencies. According to ASIC administrative data, the vast majority of insolvencies in Australia are small businesses. These businesses overwhelmingly 'failed honestly'. That is, most businesses failed because of factors like inadequate cash flow, trading losses or economic conditions, low sales, or increased competition, not because of intentional wrongdoing on the part of their directors. Indeed, ASIC data from 2006-2015 shows that, when accounting for reasons companies have failed (as identified by practitioners), fraud ranks tenth (just above companies that have failed due to natural disasters).[12]

By imposing the same requirements in every liquidation, our current system therefore risks imposing unnecessarily high regulatory impact on distressed small businesses. This has the effect of depleting their very limited asset base and reducing returns for creditors and employees. It is an efficient means of targeting and preventing misconduct like illegal phoenixing.[13]

Insolvency sector capacity

These issues are exacerbated given the significant economic impacts of COVID-19, which means their impact will be felt more acutely. The need for efficient processes that effectively meet the needs of companies is increased as a larger number of companies are expected to enter external administration over a short period as temporary support measures are wound back. As mentioned in the Background, from April to September 2020, there was a decrease in companies entering external administration of 51.2 per cent compared to the same period in 2019 (a decrease from 4,404 to 2,139). This decrease has been reasonably consistent across industries. Some notable examples include: construction that had a decrease of 60 per cent, retail trade that had a decrease of 42 per cent and accommodation & food services that had a decrease of 50 per cent. It is expected that the vast majority of these companies are small businesses.

In the absence of reforms, this may place significant pressure on our insolvency system. The approximately 3,000 companies that have deferred entering external administration will likely have to be processed by the insolvency sector following the winding back of temporary support as will other companies that have been severely impacted by COVID-19. There is currently no mechanism that allows for these external administrations to be spread over time.

The number of Registered Liquidators has steadily been decreasing in line with stagnating numbers of external administrations. In March 2017 there was 726 Registered Liquidators, which has now decreased to around 640. This body of practitioners may have been able to respond to market conditions to date. However the impacts of COVID-19 and the temporary insolvency relief, which

[11] Sewell and Kettle 2020, Liquidation, https://sklawyers.com.au/faq/how-long-does-a-liquidation-last/

[12] Productivity Commission 2015, 'Business Set-up, Transfer and Closure: Productivity Commission Inquiry Report', p. 75.

[13] Illegal phoenixing occurs when a company is liquidated, wound up or abandoned to avoid paying its debts. A new company is then started to continue the same business activities without the debt. On 5 February 2020, the Government passed legislation to implement a suite of reforms to the corporations and tax laws to combat illegal phoenixing. The legislation helps the Australian Taxation Office (ATO) crack down on those who conduct or facilitate illegal phoenix behaviour. The Australian Securities and Investments Commission (ASIC) can now pursue new civil and criminal offences against those who promote or engage in illegal phoenixing. ASIC and liquidators have additional powers aimed at recovering assets for the benefit of employees and other creditors.

have deferred a number of insolvencies, means that it is prudent to put in place measures to manage this potential shock.

Furthermore, there are barriers to entry for new or returning insolvency practitioners that will also be reduced by adding flexibility to the legislative requirements that are used by ASIC, through the Insolvency Practitioner Registration and Disciplinary Committees, to assess new applicants. There are currently a range of prescribed conditions including that the insolvency practitioner must have 4,000 hours of relevant employment (which must fit into certain categories) at a senior level during the preceding 5 years. Although there is a provision that allows a Committee to register an insolvency practitioner that does not meet all of the prescribed conditions, it requires them to be registered with conditions specified by the Committee. In practice it may be difficult for the Committee to come up with suitable conditions. These barriers disproportionately impact women who are more likely to take a break in their career.

The lack of technological neutrality surrounding the external administration provisions of the Corporations Act has also been a concern for industry due in part to the resulting regulatory burden. This includes requirements to provide notice documents in hard copy by post, and to hold meetings in physical locations (even if participants would prefer to attend virtually).

2. Why is government action needed?

While many factors impact the efficiency of markets, an insolvency system performs an important function in this regard. The government is responsible for establishing and overseeing the system. In doing so, the government establishes the ‘rules of the game’ in the event of business failure, providing certainty to investors, and thereby facilitating access to credit.

Because government sets clear rules, creditors can have the confidence to lend to a business, with the certainty that a known process will follow if that business fails. For example, the system provides creditors with the rules that will determine the amount they will recoup if a debtor company fails. Clear and fair rules in this regard apply equal treatment to creditors from the same class, and promote an orderly winding up and distribution of remaining funds in liquidation while identifying and deterring creditor defeating misconduct (such as illegal phoenixing). However, an efficient insolvency system should also provide distressed but viable businesses the opportunity to restructure and to continue to trade to the benefit of the business, its creditors and employees, and the economy more generally.

In setting these rules, governments must carefully balance several objectives, all of which an insolvency framework seeks to achieve. These include:

- allowing inefficient and poorly performing firms to exit the market in an efficient and orderly manner.
- providing an opportunity for financially distressed but viable companies to restructure and reorganise their affairs.
- promoting investor confidence through enabling a system that identifies and deters wrongdoing.

It is important that governments consider how their insolvency frameworks are meeting these objectives, and whether they are appropriately balanced.

Small business restructuring and liquidation

Reforms to the Australian insolvency system would enable it to better meet these objectives, and in doing so, support more Australian business and the broader economy.

Government action is required to meaningfully effect change. The current regulatory settings are imposed by Government legislation and as such Government action is required. Furthermore, Government is well placed to include safeguards to protect against instances of misconduct.

Providing a bespoke process targeted at small business restructure will enable Australia's insolvency framework to better meet the objective of enabling viable companies to turnaround their affairs and to continue to operate in the market. It would address many of the shortcomings of voluntary administration, particularly regarding use of this process by small business. In doing so, it would encourage more small businesses to enter into restructuring early, rather than waiting until liquidation is the only option.

A simplified restructuring process would achieve these objectives by:

- Providing a process that is simpler and more easily understood.
- Allowing for lower costs, by reducing complexity and simplifying the role of the insolvency practitioner.
- Enabling a 'debtor-in-possession' model, which allows the business owners to remain in control of the company during the process (thereby reducing their reluctance to engage with the process and supporting the continued trading of the business during the process).

Likewise, a simplified liquidation process targeted at insolvent small businesses would allow unviable businesses to be wound up efficiently and cost effectively. This would be achieved by removing unnecessary or disproportionate obligations that the current liquidation process imposes on the insolvent business and its liquidator. These obligations relate to the level of investigation and reporting required, the ability to convene meetings and the ability to appoint reviewing liquidators and committees of inspections. Tailoring the liquidation process to the small business will ensure that more of the company's remaining assets are available for distribution to its creditors and employees, rather than being used to fund obligations imposed by the process itself.

Both of the above proposals would ensure our insolvency system could continue to meet the objective of identifying and preventing misconduct through appropriate enforcement. They would include safeguards which, as opposed to blanket obligations, are targeted to enable the processes to be used by honest firms, but prevent their use and reuse to facilitate misconduct like illegal phoenixing.

The safeguards include:

- The same company or directors using the process would be prohibited from using the process more than once within a prescribed period (proposed at 7 years).
- Both processes would retain an independent practitioner, who would administer them. They would retain obligations they must fulfil on behalf of creditors, as well as the power to end the process in appropriate circumstances.
- Related creditors would be unable to vote on a restructuring plan.

Increasing the capacity of the insolvency sector

While the simplified liquidation and restructuring processes will reduce the complexities and costs associated with external administration processes for many businesses, additional measures to ensure adequate capacity in the insolvency sector are needed to fully realise the benefits these processes can deliver. Specifically, it will be important to ensure a functional, competitive insolvency system so that the system can handle an increased number of external administrations and to encourage cost savings from simplified external administrations.

There are also barriers to achieving efficient technological neutral outcomes as result of the Corporations Act requirements in respect of meetings, meeting communications and other communications with creditors. Current barriers include requirements to provide notice documents in hard copy by post, and to hold meetings in physical locations (even if participants would prefer to attend virtually). These barriers reduce the ability of insolvency practitioners to fully utilise electronic means and other alternative technologies to comply with their obligations. This adds to the costs of external administration as more traditional approaches (in-person meetings and posting of hard copy materials) are more expensive, and often slower and unnecessary.

3. What policy options are you considering?

Without law reform, when the temporary relief expires, small incorporated businesses and the insolvency sector will be required to adhere to the requirements of the insolvency framework that were in place prior to the temporary relief. With a view to simplifying and streamlining the liquidation and reorganisation process going forward, the following options are being considered:

1. Allow the temporary relief to expire (on 31 December 2020) without permanent law reform (maintain the status quo)

2. Introduce simplified insolvency processes for small businesses (based on a company's liabilities being below $1,000,000 when the process commences)[14] and improve the capacity of the insolvency sector

3. Introduce simplified insolvency processes for small businesses (based on small businesses being eligible under a current legislative definitions of small businesses[15]) and improve the capacity of the insolvency sector

Option 1 – Status quo

The status quo could be maintained by retaining the current framework for liquidation and voluntary administration for businesses of all sizes.

Voluntary administration would remain the primary formal business restructure tool for insolvent businesses, including small businesses. Business owners seeking to use this process would have to assent to have an independent administrator to manage the business during the administration. The owner would have broad powers over the running of the business, and would be required to take on personal liability for the company.

For businesses seeking to wind-up, including small businesses, would have access to one liquidation process. Full investigatory, meeting and reporting requirements would apply to all companies seeking to access the process, regardless of the complexity of the insolvency or the risk that it has engaged in misconduct. For example:

- A liquidator may convene a meeting of creditors at any time.

[14] Liabilities would be calculated so that it encompasses a broad range of liabilities incurred by the company.

[15] There is currently no uniform legislative definition of small business. A list of some of the statutory definitions was included in the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry 2018, 'Background Paper 12: Financial services and Small and Medium-Sized Enterprises', p5-6.

- Creditors of a company in liquidation may decide that there is to be a committee of inspection (described below) to monitor the liquidation and to give assistance to the liquidator.
- Liquidators can continue to pursue unfair preference payments[16] against unsecured creditors if the transaction occurred within 6 months prior to the 'relation back day'[17] (or 4 years prior if the creditor is a related entity of the company), regardless of the size of the payment and its benefit to other creditors.
- Liquidators would be required to complete and lodge a report to ASIC under Section 533 of the Corporations Act for all companies where there was any suspected wrongdoing (including minor matters that may not indicate intentional misconduct).

As a result of this, insolvency processes will continue to consume the assets of many small businesses in external administration, which can make it harder for the company to restructure if in voluntary administration and decrease the dividend to creditors in liquidation. It remains fairly common for unsecured creditors to get very minimal returns in the liquidation of an incorporated small business.

The high cost of external administration and the loss of control of the company to the insolvency practitioner in voluntary administration will continue to discourage small businesses from engaging with the system. As a result, the assets of the company may continue to be used up and small businesses that have a chance to go on trading will wind up, with a loss of economic activity and employment and lower returns to creditors. This is of particular concern in the aftermath of COVID-19, where many otherwise viable businesses may have ran up significant debts due to the impact of government-ordered lockdowns and other health measures.

The temporary relief currently allowing insolvency practitioners to more easily communicate with creditors electronically and to hold fully virtual meetings would not be extended. This will require creditors to opt into receiving electronic communication and does not allow for full flexibility in how insolvency practitioners hold meetings.

Option 2 – Introduce simplified insolvency processes for small businesses (based on liabilities below $1,000,000) and improve the capacity of the insolvency sector

Small business restructuring and liquidation

Option 2 would introduce new insolvency processes targeted at small businesses. These would target the barriers identified above, to ensure they would be accessed, and provide greater benefits to, small businesses.

A new, simplified debt restructuring process would be introduced for eligible small businesses. Unlike voluntary administration, which provides administrators broad powers to support business turnaround, this process would be targeted simply at restructuring a company's debts. In doing so, it is highly targeted at distressed but viable small businesses, who may simply need 'breathing room' to get back on their feet.

The process would require the debtor company to prepare a plan as to how it will restructure in order to maximise returns to creditors while saving the business.

[16] Unfair preferences occur where a creditor has received an advantage over other creditors, by receiving payment (or other type of transaction) for their outstanding liabilities and does so in circumstances where they knew, or ought to have known, that the company was insolvent.

[17] The relation back day is the date by which the prescribed period begins whereby transactions entered into by the company may be considered voidable.

A small business restructuring practitioner (SBRP) would oversee the development and implementation of the plan. The SBRP would be required to certify the plan and its supporting document, then provide the plan and this certification to the company's creditors.

Creditors would vote to accept or reject the plan. There would be no need for a physical meeting, with the voting able to be completed by circulation (including through electronic means). If creditors reject the plan then the company would return to the full control of its directors, who can consider next steps. An accepted plan would be put into effect and overseen by the SBRP.

The process would adopt a debtor-in-possession model, allowing business owners to retain control of their business during restructuring, provided they act within the ordinary course of business. In doing so, it responds to findings raised by the ASBFEO and others[18], that the appointment of independent administrators is a major disincentive for small businesses in accessing voluntary administration.

To ensure consistency, key aspects of the process would use parameters and definitions from existing law, including voluntary administration and 'Part IX' debt agreements in personal insolvency[19]. The moratorium on creditor claims provided during restructuring, for example, would be based on that provided during voluntary administration. The process by which a creditor verifies or disputes their claim would take account of rules applying in relation to debt agreements.

Recognising that not all distressed small businesses will succeed in being turned around, this option would introduce a complementary simplified liquidation process. This would recognise the particular circumstances surrounding small business liquidation, in particular the limited asset pool available to fund the administration and to be distributed to creditors.

The simplified liquidation would mean:

- Unfair preference payments would be narrowed for unrelated parties and subject to a materiality threshold. Under the simplified liquidation process, the payments to unrelated parties would not be set aside if they were made over three months from the relation back day, or resulted in the creditor receiving from the company less than $30,000 in value. The purpose is to prevent the costly pursuit of unfair preference payments, where these are unlikely to relate to misconduct or lead to meaningful returns for the insolvent company's other creditors.
- There would be no creditor meetings, including ad hoc meetings.
- Abolish 'committees of inspection'.[20]
- Reporting to ASIC Section 533 report would only be completed where the liquidator has reasonable grounds to believe that misconduct has occurred, with an additional materiality threshold to prevent reporting in relation to insubstantial compliance.
- Other investigatory and related reporting requirements would be simplified to better reflect the context of a small business liquidation. In particular, the reporting and investigatory requirements associated with the liquidator's three month report would also be streamlined to focus on the liquidator's actions to that time, the likely timeframe for ending the liquidation and the likelihood of creditors receiving a dividend.

[18] ASBFEO 2020, Insolvency Practices Inquiry: Final Report

[19] A debt agreement is a formal alternative to personal bankruptcy, where a debtor's creditors agree to accept part payment of debts owed in equal proportions. A debt agreement is made under Part IX of the *Bankruptcy Act 1966*.

[20] A committee appointed from among creditors to advise and supervise the liquidator.

Safeguards

The small business debt restructuring process would include a number of safeguards, in order to prevent abuse and to maintain important creditor rights:

- The role of the SBRP, who would administer the process, remains independent. The practitioner will have important obligations they must fulfil on behalf of creditors (such as certifying the plan and providing this to creditors). The practitioner can also end the process during restructuring, in the event misconduct is identified.
- Businesses would be unable to act outside of the 'ordinary course of business' (for example, by selling property) during the process, without the approval of the SBRP.
- Key creditor rights would be preserved. For example, there would be no changes to the rights of secured creditors, and similar types of debts are treated consistently.
- Directors would be required to declare that the company has not engaged in wrongdoing as part of the processes.
- Creditors would retain the right to vote on the debtor company's proposed plan and the plan must achieve the requisite majority to be binding.

The simplified liquidation process would also include additional safeguards, including the ability of the liquidator to convert the process to full liquidation where they think this appropriate. The same liquidator could then continue with the full liquidation.

Both processes would only be used once by the same directors or companies within a prescribed period (7 years). There would be an exception for companies who have been unsuccessful in developing a restructuring plan, and then seek to enter simplified liquidation shortly afterwards.

Eligibility

Under Option 2, the new processes would be available to businesses with liabilities below $1,000,000.

Around 76 per cent of companies entering into external administration in 2018-19 had less than $1 million in liabilities. Of these, around 98 per cent are estimated to be businesses with less than 20 full-time equivalent employees.

Under Option 2, the simplified processes will apply to eligible businesses registered under section 601BA of the Corporations Act. It would not apply to incorporated associations (which are regulated by states and territories) or to unincorporated businesses. Unincorporated business insolvencies are generally governed by the *Bankruptcy Act 1966* rather than the Corporations Act. The *Bankruptcy Act 1966* allows for other forms of restructuring, including Part IX debt agreements.

Increasing the capacity of the insolvency sector

To complement the introduction of new insolvency processes, Option 2 would implement a number of measures to improve the capacity of the insolvency sector.

Increasing the pool of Registered Liquidators

To increase the number of Registered Liquidators to help manage the expected increase in insolvencies Option 2 would include:

- Allowing the Insolvency Practitioner Registration and Disciplinary Committees[21] (which are the committees that consider the applications of persons to become Registered Liquidators) to register an applicant without conditions even if they do not satisfy all the prescribed statutory criteria, if the Committee believes the applicant to be suitable overall.
- Introducing new categories of eligible employment which can be counted toward the 4,000 hours of relevant employment at senior level that an applicant requires to become a registered liquidator. The new categories would capture: the provisions of advice in relation to the temporary safe harbour (the Government's temporary insolvency relief that relates to insolvent trading and statutory demands) and the permanent safe harbour (the 2017 changes that provides protection for directors from insolvent trading if they take a course of action that is reasonably likely to lead to a better outcome for the company than the immediate appointment of an administrator or liquidator); and, experience in restructuring companies or giving advice in relation to the restructure of companies.
- Allowing the 120 hours of continuing professional education (including the 30 hours required to be objectively verified) to be spread over the three years of the registration period. Currently 40 hours (including the 10 hours required to be objectively verified) must be completed in each of the three years.
- Amending the registration requirements to require only an indirect exposure to or demonstrated knowledge of bankruptcy processes. This is to clarify uncertainty in the law as to whether direct experience with bankruptcy processes at a senior level is required.
- Temporarily waiving fees associated with registration to increase the number of insolvency practitioners in the market. The $3,500 fee waiver would be in place for around two years so that it could effectively respond to a short-term uptick in insolvencies.

While the provisions mean some registration requirements will be applied in a more flexible way, this is not expected to affect the rigour of the profession. The provisions will be implemented following consultation with industry and there would still remain a requirement that an Insolvency Practitioner Registration and Disciplinary Committee be satisfied that an applicant is suitable to fulfil the functions of a registered liquidator. The additional flexibility provided to the Committees are aimed at ensuring that overly rigid rules that have little benefit in ensuring the integrity of the profession do not prevent suitable persons from becoming a registered liquidator. In addition, the current rigidity may be having negative impacts on the profession. The current continuing professional education requirements, for example, may result in women who have taken maternity leave being no longer eligible to practice, despite their previous experience.

New classification for the SBRP

Option 2 would also create a new classification of insolvency practitioner whose practice would be limited solely to the new simplified restructuring process. Doing so would ensure that the

[21] The Insolvency Practitioner Registration and Disciplinary Committees are Committees formed by ASIC on an ad-hoc basis used to register new Registered Liquidators and consider disciplinary matters. Each time a committee is formed by ASIC one committee member will be drawn from a Ministerial pool of appointees. The remaining two members of each committee consist of a representative of ARITA and ASIC.

qualifications required of the practitioner working on the new process are in line with the requirements of the role.

The new classification would be a new Registered Liquidator sub-class, as such these practitioners would be assessed by the Insolvency Practitioner Registration and Disciplinary Committees. The Committees would also be responsible for disciplinary action. It would also ensure that capacity constraints around access to the new process can be addressed, as more practitioners will be able to enter the market to meet demand for this work.

The new sub-class is proposed following consultation with a range of stakeholders. Some stakeholders argued that the sub-class should be as broad as possible so as to capture professions with existing relationships among small businesses (such as their regular accountant or financial counsellor). Others opposed the proposition for a new sub-class, arguing that industry does have capacity to manage the expected increase in the number of external administrations or that the new process would benefit from being overseen by a full registered liquidator.

These diverse views were taken into account in setting the requirements for the new sub-class of practitioner. To be eligible for this new sub-class a person must be a fit and proper person and have a public practice certificate (or equivalent) from either CPA Australia, Chartered Accountants Australia and New Zealand (CA ANZ) or the Institute of Public Accountants (IPA). By utilising existing qualifications and membership structures on the part of these professional bodies, the new sub-class will benefit from the use of these bodies' existing processes, including around continuing professional education and disciplinary processes. Importantly, prospective applicants would also need to hold indemnity insurance. In addition, an Insolvency Partitioner Registration and Disciplinary Committee must consider that the applicant is suitable to fulfil the role of a practitioner for the purposes of the new restructuring process.

The criteria for this new subclass of Registered Liquidator has been informed following extensive consultation from a variety of stakeholders. Treasury had bilateral meetings with stakeholders including ARITA, TMA, Law Council, accounting bodies and ASBFEO to discuss the appropriate eligibility requirements. In submissions to the Government's consultations on the exposure draft legislation stakeholders submitted their suggestions for the eligibility requirements.

Temporary relief for company's accessing the new restructuring process

Furthermore, it is anticipated there will be an increase in the number of companies facing insolvency following expiry of the temporary measures due to the impact of COVID-19. For example, as explained above, it can be extrapolated from ASIC data that by the end of the year around 3,000 companies that would have normally gone into external administration will not have. It will be important to manage any potential 'wave' when it is most acute, so that companies who need to access insolvency services can do so. This is particularly important where these involve restructuring, and the possible saving of the company.

As such, a mechanism is proposed to stagger the companies anticipated to access the simplified restructuring process when it becomes available. This would reduce the spike in demand that would otherwise occur when temporary support is withdrawn, and provide industry sufficient time to adapt to administering the new framework. It would use existing and known mechanisms (in the form of the current temporary insolvency relief) to achieve this.

Specifically, how the mechanism would work is that between 1 January and 31 March 2021 a company can announce its intention to access the simplified restructuring process, including by notice through ASIC's published notices website. Once this is announced, the Government's temporary COVID-19 insolvency relief (that relates to insolvent trading liability and to statutory demands) would apply to the company. The company would then have 3 months (from announcement) to consult an SBRP around access to the simplified process. These settings would functionally extend the relief already provided as part of the Government's temporary insolvency measures, where a distressed company must wait to engage an SBRP. As such, the settings would be familiar to both debtor companies and their creditors, helping them to understand the mechanism.

Technology neutrality in insolvency processes

Finally, Option 2 would also help to manage the upcoming wave of insolvencies by modifying insolvency law so that they are technology neutral. It would amend the external administration provisions of the Corporations Act to better enable technologically neutral practices during insolvency processes, namely by making it easier to communicate electronically and by permitting fully virtual meetings of creditors.

Option 3 – Introduce simplified insolvency processes for small (based on small businesses being eligible under a current legislative definitions of small businesses) and improve the capacity of the insolvency sector

Option 3 involves introducing the same new processes as in Option 2 but rather than having an eligibility threshold based on the company's liabilities, the threshold would be based on an existing small business definition in Government legislation.

Treasury has identified over 30 discrete definitions of small business across Commonwealth legislation and instruments. Some definitions are based on the number of employees. For example, the *Fair Work Act 2009* defines a 'small business employer' as an employer that employs fewer than 15 employees at the relevant time while the *Financial Services Reform (Consequential Provisions) Act 2001* uses fewer than 20 employees unless it is a manufacturing business where a small business is defined at having fewer than 100 employees. Instead of number of employees some legislation uses a definition of aggregate turnover. For example, the *Income Tax Assessment Act 1997* includes different turnover thresholds for different small business concessions.

4. What is the likely net benefit for each option?

Option 1 – Status Quo

If no reforms are progressed and the status quo persists, then small businesses and their creditors and employees will continue to be negatively impacted through reduced returns as the limited assets of small businesses are consumed by the cost of the external administration process, or the businesses are discouraged from using the system.

Under Option 1 the insolvency framework would not fully accommodate the needs of Australian small businesses. These include:

- The need to ensure that regulatory obligations are commensurate with the complexity of the business and the likelihood of misconduct.
- The need to maximise the opportunity for distressed but viable companies to restructure and survive.
- The need to maximise returns for creditors in the event that a business is wound up.

Australian businesses would continue to only be able to access insolvency processes that are the same no matter the size of the business; processes that are better suited to larger, more complex company failures, which may have greater means to engage in sophisticated forms of misconduct.

That said, reforms to address the current inefficiencies may introduce new complexity and would require industry and the insolvency sector to become familiar with any changes. This poses challenges, give that there will likely be a rise in the number of companies entering external administration following the withdrawal of temporary insolvency measures at the end of 2020. Thus, the main benefit of Option 1 is it ensures parties affected by the insolvency system remain familiar with how the system works by not making changes to it.

While maintaining the status quo may provide more certainty, it may also result in some viable companies going out of business or viable companies not being able to access professional support. Small business owners would be required to engage with current processes that have been described by stakeholders that represent both the insolvency industry (ARITA) and the small business sector (ASBFEO) as failing small businesses.

Furthermore, under Option 1 requirements to provide notice documents in hard copy by post, and to hold meetings in physical locations (even if participants would prefer to attend virtually) would remain. These unnecessarily requirements can consume assets possibly lowering the returns to creditors.

There is no impact to the Government's underlying cash balance with this option.

Option 2 – Introduce simplified insolvency processes (liabilities below $1,000,000) and improve the capacity of the insolvency sector (preferred option)

This option would apply the simplified framework to companies with liabilities of up to $1 million. This would cover around 76 per cent of external administrations of which around 98 per cent are estimated to involve companies with less than 20 FTE employees (based on companies entering external administration in 2018-19, for context in 2018-19 there were 8,105 companies that entered external administration). This would deliver substantial regulatory savings and would deliver action in an area stakeholder feedback has consistently identified as high priority. Businesses that are insolvent that can't rely on the safe harbour for protection from insolvent trading have no choice but to access an external administration process. Without the option of simplified restructuring they may be forced into a costly full liquidation.

Small business restructuring and liquidation

The simplified restructuring process would enable a debtor-in-possession model, whereby the directors of the company would remain in control throughout the process. Further, only directors could put forward a reorganisation plan. This differs from the current model used in voluntary administration, where the administrator takes full control of the company and is responsible for trying to work out a way to save either the company or its business.

The benefits of a debtor-in-possession model is that it provides business owners with more control over the process will mean the process is more aligned the needs and preferences of business owners, who will then be more amenable to its use. This will encourage them to engage in restructure when their business may still be viable, increasing the chances of its survival. The ASBFEO in their *Insolvency Inquiry Report* described how the current external administration processes is not working for small businesses:

> Small business owners report facing an opaque system, where decisions are taken out of their hands, they feel pushed into outcomes they were not looking for, and their expertise or knowledge of the business they have been running is discounted or ignored.

On the other hand, some may argue that it may not be appropriate for the small business owner to remain in control of the business particularly if they may have contributed to the business failure through misconduct. Thus transferring control to an administrator may allow for more business to restructure, be transferred to new management, and enhance the ability to identify misconduct. However, this reasoning is not consistent with the evidence stated above and the ability to design a debtor in possession model that appropriately balances and manages risks associated with misconduct.

The simplified liquidation pathway for small businesses will allow faster and lower-cost liquidation, increasing returns for creditors and employees. Under the new process, regulatory obligations will be simplified, so that they are commensurate to the asset base, complexity and risk profile of eligible small businesses. In practice simplified liquidation will reduce investigative requirements, requirements to call meetings and reduce reporting function. This will free up value for creditors and employees, and allow assets to be quickly reallocated elsewhere in the economy, supporting productivity and growth. While a simplified liquidation process aims to increase the returns to creditors this may not be possible in all cases. It is expected a number of simplified liquidations will still result is no returns being distributed to some creditors but even in such cases there will be benefits in terms of lower cost, better access to liquidation services, and a quicker liquidation.

A similar proposal to the simplified liquidation process was previously recommended by the Productivity Commission in its 2015 inquiry into *Business Set-Up, Transfer and Closure*. The Productivity Commission's simplified liquidation however, had an eligibility of threshold of $250,000 of liabilities to unrelated parties (this was the same threshold recommended by ARITA in their proposed streamlined liquidation).

In the case of this option, the $1 million eligibility threshold was chosen because it allowed for simplicity and broad coverage, while being a good indicator of the complexity of an insolvency. During consultation on this option, the Government heard a broad range of views from stakeholders on the appropriateness of the threshold, including that the $1 million threshold was both too low and too high. This is outlined in more detail at section 5. Upon considering these views, it was decided the $1 million threshold was appropriate.

The benefits of simplified restructuring and liquidation results in regulatory savings for businesses and individuals. Estimated total regulatory savings flowing from the new to restructuring process are estimated to be $23 million per year (based on an average over 10 years). Estimated total regulatory savings for changes to liquidation are estimated to be $105 million per year (based on an average over 10 years).

COVID-19 has exacerbated the impacts of shortfalls with our current system, on creditors, business and the economy. To maximise the benefits of these reforms ideally they should be in place before the expected increase in companies going through external administration occurs following the winding back of temporary support measures. Option 2 also addresses concerns that industry and companies will not be ready for the 1 January 2021 start date. In particular, Option 2 proposes that between 1 January and 31 March 2021, a company can announce its intention to access the simplified restructuring process. Once this is announced, the existing temporary insolvency relief would apply to the company. This helps mitigate the potential risks in making substantial changes during the crisis.

Methodology

This option assumes a baseline of around 4,400 businesses accessing the simplified liquidation process a year. This is based on the assumption that all eligible businesses (businesses with liabilities under $1,000,000) access the simplified process, with the estimated number of eligible businesses based on ASIC data from 2018-19 on external administration. An increase in the number of insolvencies is assumed for the first few years due to the impacts of COVID-19.

For each simplified process, the overall administrative savings (from reduced time spent on meetings, investigations and reporting) would equal around five days. This is based on reduced days the insolvency practitioner spends on investigative functions, preparing and attending meetings and time spent reporting. The regulatory costs imposed on the insolvency practitioners may ultimately be borne by the creditors as the greater the costs of the administration the smaller the ultimate returns to creditors. These creditors can be businesses or individuals. Treasury has estimated that 70 per cent of the creditors are businesses with the rest being individuals. Based on ASIC data an external administration has on average of 20 creditors. To calculate the hourly regulatory burden the standard OBPR rates of $73.05 for businesses and $32 for individuals have been used. Individuals reflects employees seeking owe income (who are typically the single largest group of creditors), as well as customers who have missed out on goods and services purchased in advance. Based on the average cost of remunerating an insolvency practitioner and running processes like meetings, this would produce estimated savings of (on average over 10 years) around $105 million annually, with $75 million annually going to businesses and $30 million annually going to individuals.

For restructuring, we assume that around 850 businesses will access the process every year (informed by the number that currently use voluntary administration procedures, which is significantly less than the number which currently enter liquidation). This assumes a time saving of around 2.5 days versus voluntary administration (associated with less time spent on debt processes and investigative function). The same base assumptions as mentioned in the simplified restructuring also apply for the simplified reorganisation process. This would produce estimated total regulatory savings of (on average over 10 years) around $23 million annually, with $17 million annually going to businesses and $6 million annually going to individuals.

While there would be a reduction over time in the number of companies which can utilise the simplified processes, due to the safeguard which means each process can only be used once by the same company/directors every 7 years, this has not been factored into the estimated take-up as we anticipate this to be a negligible number of companies compared to the increase in the number of companies which fail/are financially distressed each year. Also, this number would be offset by companies that are able to access the new simplified process but would not be able to access voluntary administration due to the costs associated with that process.

We have not factored in impacts that the new processes may have in abating unlawful company abandonment (where directors simply leave companies, rather than having them wound up by an insolvency practitioner). As this conduct is unlawful it is not clear whether reduced regulatory burden on company directors and greater returns for creditors will have a meaningful impact on it.

Increasing the capacity of the insolvency sector

In 2018-19, there were 648 Registered Liquidators in Australia, fewer than there were 10 years ago. Currently, it costs around $3,500 to apply and register to become a Registered Liquidator. Temporarily removing this cost would encourage and enable more suitable practitioners to enter (or re-enter) the market. Allowing for more flexibility in the registration of insolvency practitioners and temporarily waiving fees associated with registration as a Registered Liquidator will help to increase the number of Registered Liquidators which will help to manage the expected increase in insolvencies. As well as increasing the number of Registered Liquidators, the new classification of insolvency practitioners whose practice will be limited solely to the new simplified restructuring process will help support the capacity of the system. The new sub-class of Registered Liquidator may have an impact on some already established Registered Liquidators as they may lose some business due to the increased competition in the market. Furthermore, allowing companies to announce their intention to access the simplified restructuring process will help manage an anticipated increase in the number of companies entering external administration. However, becoming a Registered Liquidator and announcing your intention to restructure are optional so these changes are unlikely to have a material impact on regulatory savings.

There may be a risk that given the new conditions the Insolvency Practitioner Registration and Disciplinary Committees may register unsuitable people to become Registered Liquidators. However, this is unlikely given the membership and composition of Committees, and the benefits from giving Committees greater flexibility to perform their role outweighs the risk. Many requirements, such as the applicant being a ‘fit and proper person’ remain. The new flexibility allows the Committees to better use their expertise and perform their duties.

Option 2 would also help to manage the upcoming wave of insolvencies by modifying insolvency law so that it is more technologically neutral. It would amend the external administration provisions of the Corporations Act to enable technology neutral practices during insolvency processes, namely by:

- Removing the requirement for creditors to have to opt into receiving electronic communication, thereby allowing insolvency practitioners to send communications electronically if an electronic address is available.
- Giving insolvency practitioners the option to conduct meetings entirely virtually. Under the current legislation meetings are required to have a physical location and alternate locations can be linked in virtually.

Doing so will ensure that insolvency processes can be carried out as efficiently and as cost effectively as possible, while still maintaining creditors’ rights related to notification, participation and attendance. This will ensure that administrators can focus on the substantive requirements of their role, meaning they will be better placed to deal with an increase in demand for their services. Applying the changes to existing and new insolvency processes will ensure broad coverage, while building on the simplicity and cost savings that the new processes will deliver. The regulatory savings for allowing electronic communications and for moving to online meetings are estimated to be around $36 million per year (on average over 10 years).

Methodology

This option assumes a baseline of around 8,100 businesses entering external administration, based on ASIC data from 2018-19. All companies in external administration can utilise the changes to make the external administration technology neutral not just small businesses. Treasury estimates that

40 per cent of external administrations would be held completely virtually and on average an external administration has 2 to 3 meetings.[22]

Time cost of printing and other mailroom activities involved in sending a letter is assumed to be six minutes. While sending an electronic document takes one minute. The regulatory saving time is calculated using the OBPR work-related labour cost of $73.05 per hour. Printing and postal costs per actual letter are respectively $1.50 and $2.20.

As with the small business processes the average number of creditors is assumed to be 20 and an increase in the number of insolvencies is assumed for the first few years due to the impacts of COVID-19.

Based on these assumptions the regulatory savings for allowing electronic communications are estimated to be around $3 million per year (on average over 10 years) with the regulatory savings for allowing fully virtual creditor meetings to be around $33 million per year (on average over 10 years).

These regulatory savings should allow for greater returns for creditors when a company is liquidated or restructured. The reforms should also help insolvency practitioners manage capacity in the system with the expected increase in work-load from the anticipated rise in insolvencies relating to COVID-19, as well as enabling more small businesses to successfully restructure.

In total the estimated savings for Option 2 (on average over 10 years) is around $165 million annually, with $129 million annually going to businesses and $36 million annually going to individuals.

With regard to the cost to Government, there is a very minor estimated positive impact on underlying cash balance of approximately $0.4 million. This is the net result of a small increase in application fees from registered liquidators across each year of the forward estimates (due to an increase in liquidators being registered) minus the lost revenue from the waiver of registration fees for liquidators entering or re-entering the market in 2020-21 and 2021-22.

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	**Business**	**Community organisations**	**Individuals**	**Total change in cost**
Total, by sector	-$129	$0	-$36	-$165

Option 3 – Introduce simplified insolvency processes (based on small businesses being eligible under a current legislative definitions of small businesses) and improve the capacity of the insolvency sector

Option 3 uses an alternative threshold for determining which small businesses are eligible but is otherwise the same. An alternative threshold based on a business having less than 20 FTE employees

[22] During the period after which the temporary insolvency relief was implemented, Treasury held consultations, including with stakeholders from industry, to understand the dynamic of virtual meetings, and how these were being utilised and received by participants. This information has informed these assumptions.

would have captured around 5,500 businesses in liquidation and 1,100 businesses in voluntary administration in 2018-19.

For the purpose of calculations this option uses the definition of having less than 20 full-time equivalent (FTE) employees as it matches available ASIC data.

Capturing a higher number of businesses than in Option 2 results in Option 3 having a higher regulatory saving. Estimated regulatory savings for changes to liquidation are estimated to be $126 million per year (based on an average over 10 years) and for restructuring are estimated to be $29 million per year (based on an average over 10 years). As in Option 2 the regulatory savings for allowing electronic communications are estimated to be around $3 million per year (on average over 10 years) and the regulatory savings for moving to online meetings to be around $33 million per year (on average over 10 years). This equates to total estimated savings of around $192 million annually (on average over 10 years), with $152 million annually going to businesses and $40 million annually going to individuals.

Although regulatory savings may be higher, the number of employees is not considered the most appropriate way to determine eligibility. It is harder to appropriately target these changes to suitable businesses with a threshold based on employees. For example, a large complex business with large liabilities but with a mainly automated process and consequently a low number of employees may qualify under an employee based test. Data from ASIC shows that in 2018-19 there were over 100 companies which entered external administration with over $10 million in liabilities but with less than 5 FTE employees. It poses integrity risks for a debt of this scale to be captured under a simplified process. Having companies with relatively high liabilities (in some cases over $10 million) accessing a process that is designed to be simplified could have a negative impact on creditors. Unlike Option 2, under Option 3 the new simplified processes may not be commensurate to the asset base, complexity and risk profile of eligible small businesses.

There are also problems with the opposite situation. A simple business, with low debt levels but with over 20 FTE employees would miss out on the streamlined process, even when it may be appropriate for them to be included. Data from ASIC shows that in 2018-19 there were over 100 companies which entered external administration with under $1 million in liabilities but with 20 or more FTE employees. In these cases creditors and other affected parties may miss out on better outcomes that may be available to them had the company been able to go through a streamlined process.

Furthermore, the number of employees may not be an accurate indicator for companies near end of life where they may have made staff redundant. In comparison the amount of liabilities is relatively easier to understand and calculate, reflects the indebtedness of the company and creditor exposure to loss, and is difficult to manipulate. In addition, the Productivity Commission and others advocating for small business liquidation have recommended a liabilities test. In consultation the majority of stakeholders preferred a liability threshold over other types of thresholds. Similar arguments can be made for using existing definitions that use aggregate turnover instead of employees. A financially distressed business's turnover may not be reflective of its size (it is likely to be lower than would otherwise be case) or creditor exposure to the failure, and may be difficult to measure or verify.

With regard to the cost to Government, there is a very minor estimated positive impact on underlying cash balance of approximately $0.4 million. This is the net result of a small increase in application fees from registered liquidators across each year of the forward estimates (due to an increase in liquidators being registered) minus the lost revenue from the waiver of registration fees for liquidators entering or re-entering the market in 2020-21 and 2021-22.

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	**Business**	**Community organisations**	**Individuals**	**Total change in cost**
Total, by sector	-$152	$0	-$40	-$192

5. Who did you consult and how did you incorporate their feedback?

Consultation prior to announcement

On 24 September 2020, the Treasurer announced the broad framework for the insolvency reforms to support small business.

Prior to the announcement, Treasury held regular consultation with key stakeholders following the implementation of the temporary insolvency relief from March 2020. Consultation was held with various stakeholders groups including representatives of insolvency practitioners, turnaround professionals, accountants and other professionals, and small business representatives.

While the purpose of this consultation was to gauge the impact of the insolvency relief and to better understand the state of the market, stakeholders raised broader issues during these meetings. These included broader, systemic issues with Australia's insolvency framework, and the impact of these issues on business (including small businesses) in the context of COVID-19.

Issues raised included:

- The impact of extensive obligations during insolvency processing on both practitioners and business.
- How Australia's insolvency system could deal with problem of highly indebted small businesses in the aftermath of COVID-19.
- Capacity in the insolvency sector.

Feedback from these meetings was used to inform our understanding of the insolvency system, the problems facing the system, options for reform, and approaches to implement those options.

Impact of stakeholder reports and proposals

As well as conducting stakeholder meetings, Treasury analysed existing submissions and reports and used these to inform the reform proposal. These included:

- The Productivity Commission's 2015 inquiry *Business Set-up, Transfer and Closure*, proposed that the Government adopt a streamlined liquidation process for small businesses, stating, "…

there is considerable scope to streamline insolvency processes for the majority of businesses through the creation of a two stream approach."[23]

- ARITA, in its 2015 submission to the Productivity Commission review above, released a discussion paper proposing both a streamlined insolvency process and a new debt restructuring process for micro businesses.[24] ARITA reiterated its proposal in its submission to ASBFEO's insolvency practices inquiry in January 2020.[25]
- The ASBFEO, in its 2020 insolvency practices inquiry, also recommended the Government adopt streamlined insolvency processes for small businesses and argued the current regime was not working for small businesses.[26]

These proposals, as well as broader feedback on Australia's insolvency framework, where closely considered in the development of the reforms. We also note that both the Productivity Commission and the ASBFEO consulted with a range of stakeholders in undertaking their respective inquiries, meaning their reports reflect the views of a broader group of stakeholders.

Bilateral consultation following the announcement

Following the Government's announcement of the reforms, Treasury met with a variety of stakeholders including ARITA, TMA, ASBFEO, Law Council of Australia, Chartered Accountants Australia & New Zealand (CA ANZ), KPMG, the ABA, the Council of Small Business Organisations Australia (COSBOA) and the Property Council. The purpose of the consultation was to allow stakeholders to communicate their high-level views on the reform process, and to ask questions, before the draft legislation was finalised.

Generally, stakeholders voiced strong support for both the design and objectives of the new simplified insolvency processes for small businesses. Concerns, where these did exist, centred on aspects of the restructuring process, including the rights for creditors, the coverage of the moratorium on creditor claims during the restructuring process, and the potential for debtor companies to take advantage of the process. It was proposed that the coverage of the moratorium and the approach to secured creditor rights would closely reflect those provided during voluntary administration. This approach was endorsed by most stakeholders, and was subsequently reflected in legislation. Stakeholders were also generally supportive of proposed provisions preventing misuse of the process including limitations on its reuse and the need for directors to declare that they had not engaged in creditor defeating conduct.

Consultation on the draft legislation

To maximise flexibility and opportunities for stakeholder feedback, the primary legislation aimed to establish the broad framework, while allowing for key design aspects to be progressed in subordinate legislation (rules and regulations). This included the eligibility criteria to access the new processes, the qualifications for the SBRP, and the more detailed mechanics for the new restructuring process. This approach allowed for two separate periods of public consultation. A

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[23] Productivity Commission 2015, Business Set-up, Transfer and Closure: Productivity Commission Inquiry Report, p. 28.

[24] ARITA 2015, Submission to Productivity Commission review on Business Set-up, Transfer and Closure.

[25] ARITA 2020, Submission to the Insolvency Practices Inquiry, p. 23, https://www.arita.com.au/ARITA/News/Submissions/Australian_Small_Business_and_Family_Enterprise_Ombudsman_s_Insolvency_Practices_Inquiry.aspx

[26] ASBFEO 2020, Insolvency Practices Inquiry: Final Report.

shorten time for formal consultation received approval from the Legislative and Governance Forum on Corporations (LGFC).

On 4 October 2020 the exposure draft insolvency reforms Bill was made available to a number of stakeholders with whom Treasury had already consulted on the policy and on 7 October 2020[27] it was made publicly available on the Treasury website with consultation closing on 12 October 2020. The shortened consultation periods intended to allow for the legislation to be passed and the reforms to commence on 1 January 2020 in line with the expiry of the temporary insolvency relief on 31 December 2020.

The Government received 51 submissions in response to the exposure draft of the primary law amendments, showing strong stakeholder interest and engagement. A log of the submissions is at Annex 1. The vast majority of submissions were supportive of the objectives and the broad parameters of the reform proposal. Stakeholders submitted some policy considerations as well as suggestions on the technical drafting of the legislation.

The major policy issues raised related to the qualification requirements for the new SBRP, the threshold for eligibility to access the new simplified insolvency processes, and suggestions on how the primary law could best implement the announced reforms.

Consultation on the draft subordinate legislation

Following the finalisation of the Bill, exposure draft regulations and rules were released for public consultation from 17 – 24 November, during which time they were available on the Treasury website. Treasury also provided these documents to a number of stakeholders, and met with several stakeholders to discuss the exposure drafts.

As at 25 November, Treasury had received 20 submissions on the draft subordinate legislation. A log of these submissions is at Annex 2. Bilateral consultation was also held with stakeholders including the Law Council, ARITA and the TMA.

Major policy issues raised in response to the draft regulations and rules included the qualification requirements for the new SBRP, which debts could be included under a plan, the terms of a plan (including how long it could last for), and issues related to how a plan is put to creditors and voted on.

Qualifications to register as an SBRP

The proposed qualification requirements for the SBRP have been informed from feedback received during consultation. This was an issue for stakeholders, who expressed their views in both bilateral consultations and in submissions.

Some stakeholders argued that the sub-class should be broad enough to capture appropriate professions with existing relationships among small businesses (such as their regular accountant or financial counsellor). In in its submission on the draft legislation, the TMA stated:

> Due to Australia's economic success over generations there is a lack of an SME restructuring profession that is readily identifiable. It needs to be grown. In absence of that and for this

[27] Due to the proximity to the release of Budget 2020-21 the exposure draft legislation could not be released until 7 October 2020.

> reason we believe the best means of expanding the number of qualified persons who are able to perform all steps associated with the small business restructure other than an ordinary or simplified liquidation is to look to the criteria set out below. In short, the best people to help restructure a small business will be local senior accountants and possibly lawyers, particularly in suburban and regional Australia. For businesses in the agricultural sector (including farmers), involvement of rural debt counsellors may also be appropriate.

Others voiced concern around the proposition for a new subcategory. For example, in its submission on the draft legislation, ARITA stated:

> We are concerned that a new sub-class of registration for restructuring practitioners with lower qualifications, experience, knowledge or abilities requirements undermines the basis of the 2016 amendments.
>
> This places at risk progress demanded by successive Parliamentary Inquiries into insolvency that demanded higher levels of qualification and skill across all forms of insolvency administration.

Some stakeholders voiced concern that the industry may have capacity to manage the expected increase in the number of external administrations, meaning there is no need to expand the requirement from the current requirements to be a Registered Liquidator. For example, in its submission on the draft legislation, the Business Law Section of the Law Council of Australia (Law Council) stated:

> We recommend that before any decision is made to permit some lesser qualified category of practitioner to undertake such a role, some time is taken to see if the current insolvency market is able to provide adequate numbers of suitably qualified registered liquidators to cope with immediate demand that is anticipated after the proposed commencement date of 1 January 2021. Any additional time that current practitioners may need to cope with the immediate demand could be provided by granting, in the regulations, a temporary extension to the proposed restructure periods (say, for the first three months of 2021).

The proposed requirements for registration as an SBRP reflect a balance between these views. As noted, it is proposed that, to be eligible to register as an SBRP, a person must be a fit and proper person, have a public practice certificate from either CPA Australia, Chartered Accountants Australia and New Zealand (CA ANZ) or the Institute of Public Accountants (IPA) and be assessed by a registration committee as suitable. This widens the pool of professionals who can perform these services, a key priority of many stakeholders. At the same time, it addresses stakeholder concerns around preventing unscrupulous or unqualified advisers from being appointed as an SBRP.

Eligibility to access the new simplified insolvency processes

In submissions received on the draft legislation, the Government received a range of feedback on the threshold for eligibility to use the new insolvency processes:

- The majority of stakeholders preferred a liability threshold of some variety.
- Some stakeholders requested the liability threshold be coupled with another definition of small business to make sure it was properly targeted.
- Others suggested eligibility should be linked with already existing small business definitions.

Stakeholders also had divergent views on the amount that the liability thresholds should be set at. Some stakeholders believed that a $1 million threshold was too high. They argued that a $1 million threshold would capture some larger businesses that would not be suited to the processes, and potentially increase the risk of illegal phoenixing. For example, ARITA, in the covering letter to its submission on the draft legislation, stated:

> We hold significant concerns with the foreshadowed eligibility liability threshold for both the proposed restructuring and simplified liquidation processes of $1 million. We believe that a liability threshold of $250,000 of unrelated debts is more appropriate and more reflective of the small, non-complex businesses the reforms are aimed at. We believe that a $1 million threshold is too high, capturing a significant proportion of external administrations and enhancing the risk of this framework being used for phoenixing.

However, other stakeholders had a different perspective, requesting consideration be given to increasing the $1 million threshold. The intent behind this view was that a higher threshold would allow more businesses to benefit from the new processes. For example, the TMA, in its submission on the draft legislation, stated:

> We note that a cap based on a maximum of $1 million in liabilities would appear to be lower than the caps applicable to small business restructuring processes or small business liquidation proceedings in other jurisdictions…
>
> Consideration should therefore be given to whether a higher threshold would be appropriate either now or at some point in the future to ensure that the restructuring process has utility beyond very small companies.

In addition, some stakeholders also argued the threshold should be different for simplified liquidation as compared to the proposed restructuring process.

On balance after considering the feedback received, a $1 million threshold is considered appropriate. This is because:

- A liabilities threshold is the simplest and most effective conduit for the complexity of an insolvency, a fact some stakeholders acknowledged. It appropriately focuses on creditor exposure and is relatively transparent, easily measured and difficult to manipulate. For this reason, a liabilities threshold was previously proposed by both ARITA and the Productivity Commission (albeit at a lower value). A liabilities test is used elsewhere to determine access to small business insolvency processes, including under Chapter 11 of the United States Bankruptcy Code.
- Alternative thresholds linked to existing small business definitions (for example, those based on FTE employees) introduce their own complexity (for example, in requiring companies to calculate how many part-time staff constitute a fixed number of FTE employees). These alternate approaches may be easier to mismeasure or manipulate, and may not accurately represent the complexity of an actual insolvency. Consistency benefits would also be lost if a definition linked to another law was changed.
- Setting the threshold at $1 million will pick up an appropriate proportion of companies who enter insolvency processes (estimated at around 76 per cent, based on historical insolvency statistics). This responds to a key stakeholder concern, which was to ensure the process is available to as large a number of companies as possible. While the $1 million threshold is higher than that previously proposed by ARITA and the Productivity Commission, some stakeholders argued it should be higher while others supported it. As noted, additional protections already exist to guard against illegal phoenixing.

The provisions setting out eligibility for the process are set out in the regulations.

Length of a restructuring plan

The draft regulations proposed that a restructuring plan could run for a period of up to five years. There were mixed views on whether this was an appropriate timeframe.

The policy intent of the five year period was to provide debtor companies sufficient flexibility to pay off debts under the plan. However, some stakeholders proposed a shorter maximum period, noting that a shorter period would reduce uncertainty around whether creditors would be paid, thereby providing more confidence. Stakeholders also noted that timeframes for repayment under similar regimes, including deeds of company arrangements and Part IX debt agreements, are typically shorter than what was being proposed.

For example, in its submission on the exposure draft regulations and rules, the Australian Banking Association stated:

> Under regulation 5.3B.13(4)(b) a restructuring plan may provide for payments to be made for a period of up to 5 years. Given the aim of the restructuring process is to effect an expedited restructuring of small business this period is too long. The expectation is that small businesses utilising the restructuring process will have relatively simple debt structures and simple assets to be realised to satisfy those debts. Such assets should be capable of being realised within a short period of time. The restructuring period should reflect the aim of quickly restructuring small business.
>
> Under existing comparable regimes – voluntary administration and deeds of company arrangement -timeframes for repayment are usually much shorter than 5 years. The restructuring plan should allow for payments over a period of no more than 1 to 2 years. The longer a restructuring plan is in place, the longer uncertainty about the business's financial capacity will remain, restrict its access to capital and allows for costs to be incurred. The proposed period of up to 5 years does not appear consistent with the aims of the new process.

In light of this feedback, the maximum period for a restructuring plan was amended to 3 years. This was designed to balance the concerns raised by some stakeholders with the original policy intent of providing appropriate flexibility for the debtor company. This also reflects the period for which a Part IX debt agreement can run (in instances where the debtor does not own their home).

Amendments to the maximum period for a plan were made in the final regulations.

Admitting new debts to a plan

The exposure draft proposed that creditors would have 5 business days in which they could request to vary their claims following the provision of a plan to the creditor. This timeframe was put in place so that the practitioner would have sufficient time to respond to this request for variation. It was also proposed that only unrelated creditors (who were not in an existing plan) could request to enter a plan once it was made. The intent was to minimise the risk of related parties not fully disclosing debts up front in order to promote a company's access to the new process.

During consultation on the regulations, stakeholders expressed several concerns around this process:

- Some stakeholders raised concern that the 5 business day period in which creditors had to certify or request to vary their claim was too short.
- Some stakeholders raised concerns about the circumstances in which new creditors could be admitted to the plan.
- Some stakeholders raised concerns that existing creditors lacked an avenue to amend their claim, if extraordinary circumstances prevented it from being made in the first instance.

The final design of the law sought to balance these various interests and concerns. In particular, the draft law was amended so that:

- Creditors would have 5 business days in which they could request to vary their claims following the provision of a plan to creditors.
- The SBRP could choose to consider variations after this period, and up to the making of a plan, provided the creditor provides a justification as to why this wasn't provided in the initial five business day period.
- Following the making of a plan, new creditors as well as variation requests from existing creditors can be admitted into the plan, where the creditor provides a justification as to why this request wasn't provided prior to the making of the plan. The SBRP then has discretion to admit these requests in appropriate circumstances.

This approach seeks to address stakeholder concerns and to ensure policy objectives are met, by:

- Ensuring there is an incentive for creditors to lodge any requests to vary their claims in the initial five day period.
- Providing a means by which requests for variation can be admitted after this period, but at the discretion of the SBRP.
- Providing a means to admit variations and new claims after the plan is made, but using a suitably high threshold (thereby providing certainty for existing creditors who have endorsed and are party to the plan).

Remuneration for SBRPs

The exposure draft Rules specified that remuneration for an SBRP could only take the form of amount specified prior to their appointment, and agreed with by the board of the company that had appointed them. The intent of this 'fixed' fee was to ensure transparency around the price of an SBRP's services, and to encourage competition in the market for these services.

Several stakeholders raised concerns about the impact of a fixed fee structure, particularly in the event that the SBRP faced costs that were not anticipated when the cost was settled. A major concern included the costs that an SBRP could face as a result of litigation.

For example, in its covering letter on its submission on the exposure draft regulations and rules, ARITA stated:

> The level of uncertainty and possible complexity, including the potential for litigation, for a set fee is likely to dissuade many experienced practitioners from accepting an appointment as a restructuring practitioner.

To address this concern, the final Rules include an exemption from the fixed fee structure for costs incurred by an SBRP, where these are associated with defending legal actions brought by other parties. The intent is to remove the potential for a major, and uncertain, variant on the expected cost of a restructuring. The exemption only extends to defending legal actions, so there is no incentive for the SBRP to launch legal action themselves. At the same time, the broad benefits of the fixed structure are retained.

Technical and operational changes

In response to stakeholder feedback and further review, further amendments were made to the primary legislation in the period following consultation on the draft Bill. These are largely based on issues that stakeholders raised and which they argued were important to ensure the effective operation of the new processes. Examples of the changes include:

- amending the ipso facto stay provisions (which prevent creditors from terminating contracts because of an insolvency event) applying during the debt restructuring process so that they apply to contracts entered into from 1 July 2018. This aligns with the scope of the ipso facto stays currently provided for companies in voluntary administration.

- clarifying that debts incurred during the debt restructuring process prior to making a restructuring plan will be provable (that is, claimable by a creditor) in the event that the company subsequently enters liquidation.

- providing a new regulation making power, which allows for regulations to specify cases that are or are not in the 'ordinary course of business'. Under the new restructuring process, company directors must seek approval from a small business restructuring practitioner for actions that fall outside this threshold.

During consultations, stakeholders indicated support for these changes which are reflected in the primary legislation.

In response to stakeholder feedback, further amendments were also made to the regulations and rules to ensure they operated as intended. These included:

- ensuring that the provisions around more flexible continuing professional education (CPE) requirements for registered liquidators operated effectively (that is, that they benefited existing registered liquidators, not just those who had newly registered);
- ensuring that the requirements around notification of creditors are applied consistently (for example, that creditors are notified where a plan lapses, regardless of the reason for it lapsing); and
- addressing instances where there were inconsistencies in terminology between the draft regulations and the Bill.

6. What is the best option from those you have considered?

Option 2 is the preferred Option as it produces a number of regulatory savings and other improvements to the insolvency regime, while being appropriately targeted and addressing the risk of misconduct. The benefits for Option 2 include:

- Lowers the costs of liquidation and restructuring for small businesses, promoting higher returns for creditors when insolvent businesses are required by law to enter an insolvency process.
- Removes processes which are not necessary for small businesses.
- Allows more businesses to successfully restructure when they face insolvency, rather than having to access an alternative process like liquidation.
- Provides more control to business owners and encourages them to restructure.
- Keeps important safeguards to protect against corporate misconduct including illegal phoenix activity.
- Requires more complex businesses to go through the full liquidation and voluntary administration processes.
- Helps to manage any anticipated wave of external administration.
- Increases industry capacity to deal with an increased number of external administrations effectively and efficiently, so that the market can better respond to changes in demand for insolvency services including in the aftermath of COVID-19.
- Changes registration requirements for insolvency practitioners to improve industry capacity and diversity.
- Reduces fees to encourage new practitioners, boosting capacity and competition.
- Enables greater usage of technology neutral practices in insolvency processes.

7. How will you implement and evaluate your chosen option?

The chosen option will be implemented through legislative changes to the *Corporations Act 2001* and related subordinate legislation. Subordinate legislation includes changes to the *Corporations Amendment (Corporate Insolvency Reforms) Regulations 2020, ASIC Supervisory Cost Recovery Levy Regulations 2017* and the *Corporations (Fees) Regulations 2001,* as well as rules made under the *Corporations Act 2001.*

Assuming legislation is passed and the reforms commenced, the new processes would be subject to ongoing monitoring to ensure they operate effectively. We will consider options, including post-implementation review, following the commencement of the new processes. The Government will continue to engage with stakeholders to determine the effectiveness of the new processes.

Regulatory burden estimate (RBE) table

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	**Business**	**Community organisations**	**Individuals**	**Total change in cost**
Option 1	$0	$0	$0	$0
Option 2	-$129	$0	-$36	-$165
Option 3	-$152	$0	-$40	-$192

Annex 1: Submissions Received on Draft Primary Law

No.	Submission
1	SM Solvency Accountants
2	nem
3	Mr Chandrasegaran (Solicitor)
4	Vantage Performance
5	*Confidential*
6	Anequity
7	SV Partners
8	Jones Day
9	Turnaround Management Association (TMA)
10	Australian Small Business and Family Enterprise Ombudsman (ASBFEO)
11	Property Council of Australia
12	Mr McKillop (Barrister)
13	Dr Mogg (Researcher)
14	DW Advisory
15	Australian Finance Industry Association (AFIA)
16	Financial Counselling Australia (FCA)
17	CA ANZ
18	Association of Independent Insolvency Practitioners (AIIP)
19	Southern Steel Group
20	Grant Thornton
21	Business Law Section of the Law Council of Australia (Law Council)
22	Barret Walker
23	Mendelsons Lawyers and Prushka Fast Debt Recovery
24	Australian Restructuring Insolvency & Turnaround Association (ARITA)
25	KPMG

26	Shopping Centre Council of Australia (SCCA)
27	Dye & Co
28	Worrells
29	Mr Wellard (Academic)
30	Australian Institute of Credit management (AICM)
31	Mr Arbogast (Barrister)
32	Australian Banking Association (ABA)
33	The Institute of Certified Bookkeepers
34	Australian Institute of Company Directors (AICD)
35	MinterEllison
36	MCorp Advisory
37	Australian Chamber of Commerce and Industry (ACCI)
38	Pitcher Partners
39	*Confidential*
40	*Confidential*
41	Mr Harris (Academic)
42	DLA Piper
43	McGrathNicol
44	Mr McDonald (Barrister)
45	Mr Eskdale (SME Adviser)
46	Mr Brown (Academic)
47	Institute of Public Accountants (IPA)
48	Australian Credit Forum (ACF)
49	CPA Australia
50	Mills Oakley
51	Council of Small Business Organisations Australia (COSBOA)

Annex 2: Submissions Received on Draft Regulations and Rules

No.	Submission
1	Shopping Centre Council of Australia (SCCA)
2	Mr McDonald (Barrister)
3	MinterEllison
4	Australian Institute of Company Directors (AICD)
5	Business Law Section of the Law Council of Australia (Law Council)
6	DCA Group
7	Charted Accountants Australia and New Zealand (CA ANZ)
8	Australian Restructuring Insolvency and Turnaround Association (ARITA)
9	NSW Small Business Commissioner
10	Australian Credit Forum (ACF)
11	Australian Banking Association (ABA)
12	Mr Wellard (Academic)
13	*Confidential*
14	CPA Australia (CPA)
15	Institute of Public Accountants (IPA)
16	Australian Finance Industry Association (AFIA)
17	*Confidential*
18	Property Council of Australia (Property Council)
19	Australian Institute of Credit Managers (AICM)
20	Australian Small Business and Family and Enterprise Ombudsman (ASBFEO)