Australian Finance Industry Association Limited
ABN 13 000 493 907
L11, 130 Pitt Street Sydney NSW 2000
T: 02 9231 5877
www.afia.asn.au

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Manager
Market Conduct Division
Treasury
Langton Crescent
Parkes ACT 2600

By email: *MCDInsolvency@Treasury.gov.au*
cc: Matthew Bowd & Christine Barron

Dear Matthew and Christine

AFIA COMMENTS ON THE DRAFT RULES, REGULATIONS AND EXPLANATORY MEMORANDUM (KEY INSOLVENCY DOCUMENTS)

The Australian Finance Industry Association (AFIA) welcomes the opportunity to provide further feedback on the key insolvency documents.

AFIA supports continued efforts by the Commonwealth Government to respond to the effects of the COVID-19 pandemic on the economy.

You will recall that in our letter of 12 October 2020, we outlined that the overarching principles and measures of success for the proposed streamlined framework and key insolvency documents - that they needed to strike a balance that afforded small to medium businesses an opportunity to be restructured or liquidated in a cost effective, efficient and streamlined manner which did not:

1. Materially disrupt the current security hierarchy (i.e., rights and remedies available to secured and unsecured creditors).
2. Negatively impact future access to credit (via domestic and international funding markets who rely on this hierarchy to right price small business facilities).
3. Lead to inadvertent consequences for creditors, many of whom are themselves small businesses.

AFIA recommendations

We recognise the compressed timeframes in which the key insolvency documents are seeking to be implemented.

More detail is provided in Attachment A and B but to maximise the opportunity of delivering the Government's stated objective i.e., "*reposition our insolvency system to help more small businesses restructure and survive the economic impact of COVID-19*,[1]" we recommend that as part of the next iteration of key insolvency documents:

1. More detail is provided in relation to how to value and realise security during the restructuring process - including if necessary, a dispute resolution process.
2. Further consideration is given to the skills and capabilities necessary to be appointed as a Small Business Restructuring Practitioner (SBRP).
3. Brokers should not receive a referral fee for introducing a SBRP.
4. If a restructuring proposal fails, then the company should automatically be placed into liquidation.

[1] Insolvency Reforms to Support Small Businesses Recovery – Josh Frydenberg

5. A review of the effectiveness of the key insolvency documents and insolvency law changes is undertaken within 9 months of them coming into effect.
6. Vesting, under the Personal Property Securities Act 2009 (PPS Act), does not occur on the appointment of a SBRP.

Concluding comments

AFIA supports the central intent of the proposed amendments.

We now encourage Treasury to consider our recommendations so that together, we help as many businesses as practicable get through the COVID-19 crisis.

Should you wish to discuss our feedback further, or require additional information, please contact Naveen Ahluwalia, Director of Policy and Regulatory Affairs at naveen@afia.asn.au or myself at karl@afia.asn.au. We can both be reached on 02 9231 5877.

Yours sincerely

Karl Turner
Executive Director, Policy & Risk Management

ATTACHMENT A

Further technical details of our recommendations on specific components of the Regulations are outlined in Attachment B. In summary, our key recommendations are set out below.

RECOMMENDATION 1: PROVIDE FURTHER DETAIL AROUND HOW TO VALUE AND REALISE SECURITY DURING THE RESTRUCTURING PROCESS – INCUDING IF NECESSARY, A DISPUTE RESOLUTION PROCESS

The valuation of security is a key pillar of the proposed regime given that only the shortfall in the value of security is included in the proof of debt and voting process – both of which are required to enable a restructuring plan or a simplified liquidation process to occur.

However key insolvency documents and section 5.3B.25(e)(i) provide insufficient clarity on how the value of the security is to be determined, nor is there any dispute resolution mechanism should a restructuring practitioner disagree with a secured creditor's determination of value.

We have provided an example to assist with your understanding of the issue that needs to be addressed:

A small business café is seeking a restructure. Due to COVID-19, the café has not been able to make any payments to its creditors for the last six months. These include payments to its small goods suppliers (for goods supplied but not paid for), its landlord (for rent on the lease of premises) and its equipment financier (for lease payments on the cafe fit-out - say $3,000). The equipment financier has registered security under Personal Property Securities Act 2009 (PPS Act), for the fit out and the value of security is $1,500.

As we understand the current drafting, the small goods supplier can claim for the value of outstanding invoices, the landlord can claim for the value of outstanding rent. However, the equipment financier will only be able to lodge a proof of debt for the outstanding lease commitments less the value of security. Fit out has very little practical value if not sold with the business (i.e., a fit-out cannot be dismantled and sold).

Under this example:

- The equipment financier is likely to claim the value of the security is $0 and lodge a claim for $3,000 to maximise their claim against the café in the restructuring process.
- The café owner is expecting a claim for $1,500 to be lodged as a proof of debt.

This is a common scenario that we envisage will arise in many small businesses and has the potential to cause disputes and extend the timeframe of the restructuring process.

We recommend that changes are made to key insolvency documents to address this issue as well as to include a dispute resolution mechanism to resolve differing valuations.

RECOMMENDATION 2: SKILLS AND CAPABILITY OF SBRP

The restructuring framework and its processes are complex and require, for example, a thorough understanding of insolvency law. As a result, in addition to being at least a qualified accountant, we recommend that the Committee, convened by ASIC to assess potential candidates, ensures SBRPs have the demonstrated skills, expertise and capacity to the perform the functions and duties of a registered liquidator.

RECOMMENDATION 3: BROKERS NOT TO RECEIVE REMUNERATION

As currently drafted, the key insolvency documents provide the SBRP with the ability to pay referral fees to brokers from company funds.

We recommend this provision is removed as we are concerned that it could lead to poor behaviour, potential misconduct and is an inappropriate use of funds of a company that is already potentially insolvent.

RECOMMENDATION 4: IF A RESTRUCTURING PROPOSAL FAILS, THERE SHOULD BE A REQUIREMENT FOR A COMPANY TO IMMEDIATELY ENTER INTO LIQUIDATION

A company that enters a restructuring process is very likely insolvent or close to being insolvent. If creditors, who by majority, choose not to approve a restructuring proposal, the company should move into liquidation and should not be able to get the benefit of the voluntary administration process.

We believe that this requirement is important to ensure integrity in the process and to prevent arbitrage or small business 'gaming' creditor appetite.

RECOMMENDATION 5: UNDERTAKE A REVIEW OF THE NEW FRAMEWORK POST COMMENCEMENT

The timing of the commencement of the reforms is compressed and the reforms are a significant change to the current regime.

As we are concerned that there is insufficient time to educate small business, key stakeholders and upskill practitioners on the new legislation as well as allow them time to upgrade systems and processes to allow for example around electronic voting and communications, we recommend an initial review of the process occurs after 9 months. Part of the terms of reference for this review, should focus on:

- The number of businesses using the new processes.
- Whether the processes are working from the perspectives of insolvency practitioners, businesses and secured and unsecured creditors.

We recommend that the Minister for Employment, Skills, Small and Family Business lead that review and that a further, more robust formal review occur commencing 1 July 2022.

RECOMMENDATION 6: PPS ACT AMENDMENT

Treasury's email on 12 November 2020 noted that alongside the Corporations Amendment (Corporate Insolvency Reforms) Bill 2020, there would be amendments made to the PPS Act, with the effect of amending section 588FL of the Corporations Act and adding the following instances in which property vests:

a) a SBRP for the company is appointed under section 453B, and
b) a company makes a restructuring plan under Division 3 of Part 5.4B.

Our members have expressed concern that this practically means that unperfected security interests will vest on the appointment of a restructuring practitioner. This seems inconsistent with the purposes of the reforms which is to engage in a formal debt restructuring to allow companies to trade through financial difficulty.

As a result, we recommend that the vesting does not occur at that point.

ATTACHMENT B - KEY RECOMMENDATIONS ON EXPOSURE DRAFT REGULATIONS

Section	AFIA Comments and Recommendations
5.3B.02(1)	This section lists the events that will provide for the end of the restructuring of the company. We note that it is important to ensure that there are protections in place to reduce the risk that companies (and their directors) commit to restructuring period that are credible and do not go for too long. As a result, we recommend the restructuring period ends after 2 years.
5.3B.02(2)	A director's declaration should be able to be ended on the same day that the director's declaration is given. We recommend this section be amended to give this clarity.
5.3B.05(3) & (4)	We suggest that these two requirements are revised. If a consent notice has been provided in writing under (2), then there should be no requirement to keep or give a written record. We agree that a written record under (3) should only have to be provided when the consent in (2) is given orally.
5.3B.13(3)	This provision states that the (restructuring) plan may "provide for any matter relating to the company's financial affairs". We recommend that these matters should not extend to the extinguishment of guarantees (i.e., a guarantee given by the company that has not yet crystalised, or a guarantee of the company's debt given by a third party). These should be pursued after the restructuring period has ended.
5.13B13(4)	As outlined in 5.3B.02(1), we recommend a maximum period of two years. Our recommendation is influenced by the learnings from the evolution of Debt Agreements and is based on ensuring that there are protections in place to reduce the risk that companies (and their directors) commit to restructuring plans that are credible and do not go for too long.
5.3B.15(4)	We recommend that there be a limit on how long the Court can extend the proposal period, noting that the restructuring is different to a voluntary administration as there is no external administrator personally liable to protect creditors for debts incurred during the period.
5.3B.16(1)	We note that s453E refers to the restructuring practitioner for the company making 'a declaration to creditors in accordance with the regulations'. This regulation states that the 'company's restructuring practitioner must prepare a certificate'. Please confirm that this certificate is the same as the declaration as consistent terminology will be important to be used.
5.3B.16(2)(d)	We recommend this provision be removed. In our view the ability to pay referral fees to brokers (from company funds) can lead to potential misconduct. We also believe that it is an inappropriate use of funds of a company that is potentially insolvent.
5.3B.16(4)	We share ARITA's concerns regarding the extent of 'inquiries' and 'reasonable steps' required by the restructuring practitioner to verify 'the company's business, property, affairs and financial circumstances' for their certification. While no requirement exists to report on these matters, investigations will still need to be conducted, noting the wording of the requirements has substantial similarity to the requirements for a voluntary administrator's report.
5.3B.16	We note that the test in relation to investigation of the company's affairs, and certification of the plan is that of 'reasonableness' which is inherently subjective. We recommend that further guidance be provided on what steps a

Section	AFIA Comments and Recommendations
	restructuring practitioner would have to take in both undertaking the investigation and in certifying the plan to satisfy the reasonableness test. We believe further guidance is important given section 5.3B.16 (in not meeting the reasonableness test) is a strict liability offence.
5.3B.18	We recommend there be a requirement to notify creditors and ASIC if a restructuring plan lapses or is cancelled. Currently there are no notification requirements.
5.3B.20(5)(b)	We note this section provides an obligation for the restructuring practitioner to notify creditors if the variation in the schedule of debts is 'significant'. As this term is not defined, we recommend that a percentage amount of variance should be used as a test for where notification is required.
5.3B.22(a)(i)	We suggest that accrued entitlements (such as annual leave and sick leave) should be excluded along with contingent entitlements.
5.3B.25	The valuation of security is a key pillar of the proposed regime given that only the shortfall in the value of security is included in the proof of debt and voting process – both of which are required to enable a restructuring plan or a simplified liquidation process to occur. However key insolvency documents and section 5.3B.25(e)(i) provide insufficient clarity on how the value of the security is to be determined, nor is there any dispute resolution mechanism should a restructuring practitioner disagree with a secured creditor's determination of value.
5.3B.29	This section raises a broader issue as to how all creditors of a business become aware that the business is under a restructuring process. We recommend that public advertising requirements are incorporated into the regulations when a restructuring practitioner is appointment.
5.3B.29(7)(b)	We share ARITA's concerns in relation to this provision. This provision encourages companies to exclude creditors from the schedule of debts and claims in order to meet the $1 million eligibility threshold, with there being no adverse consequence to doing so. We recommend that there needs to be a form of consequence either against the company or the directors if shown to manipulate the eligibility threshold.
5.3B.38	This section raises two questions: • who is responsible for debts incurred during the restructuring process; and • does the restructuring practitioner have any liability during the restructuring process. We note that a right of indemnity has been introduced for the SBRP. However, the question of liability remains unclear on this point. On the one hand it seems that restructuring practitioners are not liable for any debt or action undertaken in good faith and not negligent. On the other hand, they are indemnified by the assets of the company in priority which indicates some level of liability. We recommend there needs to be clarification as to: • who is responsible for debts incurred during the restructuring period; and • what liability does a restructuring practitioner have within the restructuring process.
5.3B.39(5)	Please confirm that the restructuring practitioner does not have the power to borrow money – and if this is the case, this provision is redundant.

Section	AFIA Comments and Recommendations
5.3B.44(2)	We query a director's ability to have sufficient knowledge of s588FE to provide this declaration. Please confirm the restructuring practitioner would be able to assist with this determination. Our members also suggest that some of these requirements appear to be a difficult to follow for directors without detailed knowledge and understanding of insolvency laws. For example, they are unlikely to know the definition of a voidable transaction. We therefore recommend an education program and plain English guide be developed to improve the financial literacy of small business directors.
Schedule 2 – section 2 and 3	We note that the Amendment continues the current temporary relief for companies i.e. a 6-month period to comply with a statutory demand and the $20,000 minimum prescribed amount for those companies that would be eligible for temporary restructuring relief, with the relief available until 31 July 2021. We are concerned that this amendment may be confusing to creditors issuing statutory demands i.e., in practical terms, how will a creditor know if the demand is for a 21 days or 6 months period. We note that some creditors may not know that a company is seeking to appoint a SBRP(so would get the benefit of the relief). We recommend that the time period to comply with statutory demands needs to be consistent, regardless of whether the company is eligible (and seeking) restructuring.
5.5.02	As above, we note that it is unlikely directors will be unable to make a declaration regarding s 588FE without specialist advice and review of company records. Independence standards prohibit the liquidator assisting with this, particularly given this information is material to the liquidator's decision whether to adopt the simplified liquidation process.
5.5.03	We recommend, as above, that liabilities (as defined as excluding secured, partially secured or related party debts) do not exceed $0.5m not the proposed $1m as, currently, 78% of businesses in insolvency have liabilities of under $1m
5.5.04	The drafting of this provision and the Exposure Draft Explanatory Statement are unclear. We assume that a transaction is not an unfair preference claim if it was entered into within 3 months of the relation back date and if it is under $30,000. This means that if a transaction is over $30,000 and occurred between month 3-6 of the relation back date then it could be a voidable transaction. We recommend that this provision is redrafted so that the intent is clearer.
Insolvency Practice Rules (Corporations) Amendments (Corporate Insolvency Reforms) Rules 2020	
5/20-2(2)(b)	The legislation and processes are exceedingly complex. We are concerned that the qualifications, experience, knowledge and abilities requirements for a restructuring practitioner application do not reflect the highly technical requirements and obligations these restructuring practitioners will need to comply with. We recommend the certification process be tightened to mirror that of a registered liquidator.