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MICRO AND SMALL ENTERPRISES AND SMALL AND MEDIUM ENTERPRISES

JUSTICE ASHLEY BLACK, SUPREME COURT OF NEW SOUTH WALES, AUSTRALIA

The Australian insolvency regime generally

We have had the benefit of Justice Romaine's outline of the practical and policy factors which arise in restructuring of micro, small and medium enterprises ("MSMEs).[1] I will adopt that helpful framework in explaining and assessing the Australian approach towards MSME insolvency, which was introduced with good intentions but has not been widely used and provides a useful lesson in the practical difficulties in law reform in this area.

Under the broader Australian insolvency regime, personal insolvency is governed by the *Bankruptcy Act* 1966 (Cth) and corporate insolvency by Ch 5 of the *Corporations Act* 2001 (Cth). The primary Australian corporate insolvency regime has the typical features of an insolvency regime directed to larger companies, described by Davis et al as follows:

> "Modern insolvency laws have tended to be designed with larger entities in mind. They generally envisage two key comprehensive types of proceedings, one for liquidation and another for reorganisation. Such proceedings involve insolvency professionals, the supervision of the Court, and other oversight mechanisms, such as a creditors' committee. These proceedings are often unwieldy and too expensive for smaller businesses. They may also lack adequate mechanisms to deal with the effect of business insolvency on individual entrepreneurs, particularly on their ability to make a fresh start."[2]

The Australian regime is broadly consistent with the objectives of insolvency regimes, also noted by Davis et al as follows:

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[1] For the basis of that approach ,see R. Davis et al, *Micro, Small and Medium Enterprise Insolvency: A Modular Approach*, Oxford University Press 2018. For additional commentary, see World Bank Group, Report on the treatment of MSME insolvency, 2017; R J Landry II, "Enhancing Rescue in Chapter 11: Lessons from Reform Efforts in the United Kingdom" (2020) 57 *Am Bus LJ* 227; J Sarra, "Making Insolvency Law Responsive to the Needs of Financially Distressed Micro and Small Enterprises" in P J Omar et al, *Research Handbook on Corporate Restructuring*, 2021, pp 247-260; R J Landry II, "Sub-Chapter V and the COVID-19 Disruption: Did Congress get small business bankruptcy reform right this time?" (2021) 16 *Ohio St Bus LJ* 66; A Gurrea-Martinez "Implementing an Insolvency Framework for Micro and Small Firms" (2021) 30 *Int'l Insolvency Rev* S46; UNCITRAL Legislative Guide on Insolvency Law for Micro and Small Enterprises, 2022; and, as to the Australian regime, J Harris, Should Voluntary Administration remain a One Size Fits All Procedure? Do we need a fast track system for small business restructurings?" in S Griffiths et al, *Evolving Tensions in Finance Law*, 2014, pp 101-126; A Morrison, "Pt 5.3B: Move Along Folks, Not Much to see Here" (2021) 29 *Insol LJ* 197; J Harris & C Symes "The Chimera of Restructuring Reform, an opportunity missed for MSMEs in Pt 5.3B" (2021) 36 *AJCL* 182.

[2] Davis, p 18

> "Many countries with developed insolvency regimes reflect core objectives of preserving and maximising the value of the insolvency estate, ensuring fair distribution over an appropriate period of time of the highest feasible proportion of that value to creditors and other stakeholders, and providing remedies for any wrongdoing connected with the insolvency. Critically important to these objectives are timely and effective mechanisms to address enterprise distress ... The deferral of dealing with distress in term depletes value that may have been made available to other creditors in a speedy liquidation."[3]

Under the Australian regime, a liquidation or winding up of a company can take place as a voluntary liquidation initiated by a company's shareholders or by a court-ordered liquidation.

The primary alternative to a liquidation in Australia is a voluntary administration under Pt 5.3A of the *Corporations Act*, by which control of a company that is insolvent or likely to become insolvent passes to an independent insolvency practitioner (called the "voluntary administrator") who has control of the business. There are three possible outcomes of a voluntary administration, that the company is (rarely) returned to its directors without further steps being taken; or it is restructured by an agreement (a "deed of company arrangement" or "DOCA") which involves a compromise between the company and its creditors, often involving a compromise of creditors' debts and further funding contributed by the company's directors or shareholders; or, if restructuring is not possible, the company is placed in liquidation. The voluntary administration regime involves a significant level of investigation by the voluntary administrator, although that occurs over a relatively short time period, and a significant level of reporting to creditors. The obvious difficulty with the application of the voluntary administration regime to MSMEs is that neither the MSME nor its directors or shareholders may have sufficient funds available to fund the work that would need to be undertaken by the voluntary administrator. Australia also allows creditors' schemes of arrangement but they (by contrast with members schemes in solvent companies) are relatively rare.

The issues with MSMEs

Turning now to the failure of micro, small and medium enterprises ("MSMEs"), Davis et al recognise that the risk of failure of MSMEs is increased by their small size, lack of funding, lack of diversification in their business, and governance issues. They also point to a real risk to the wider economy of an inability to restructure MSMEs particularly where they represent a significant component of commercial activity, or a significant part of commercial activity in particular sectors such as hospitality and construction.[4] They also recognise that the failure of MSMEs may have wider individual implications, where owners of small businesses will often have secured business loans with personal assets or personal guarantees, and that a "one size fits all" strategy is not appropriate.[5]

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[3] Davis, p 30
[4] Davis, p13.
[5] Davis, p17.

There is a corresponding advantage in adopting an insolvency regime, and particularly a restructuring regime, which minimises the loss of value when an MSME is subject to financial difficulties. It is also widely accepted that an approach to MSME insolvency should reflect fairness and seek to preserve the ongoing value of business, by restructuring rather than liquidation if possible[6] and that a regime for MSMEs needs to recognise that stakeholders will not have extensive expertise in restructuring and that creditors may be passive, and recognise the need to fund the business through an insolvency process.[7] The minimisation of costs is significant in MSME restructurings, but there is still a real risk that limits to the availability of remuneration for insolvency practitioners will have the result that they are not prepared to accept appointment in MSME restructurings, unless such remuneration is publicly funded.[8]

Davis et al respond to these difficulties by suggesting a "modular" approach, by which a basic liquidation structure would lead to the discharge of the "entrepreneur" involved with a company at its completion, and a basic reorganisation proceeding would lead to "plan implementation". They then identify additional creditor-initiated modules for reorganisations comprising (1) mediation, (2) a completing plan proposal, (3) a moratorium on "entrepreneur action", (4) involving an insolvency professional and (5) terminating a plan that is bound to fail, and additional "entrepreneur-initiated" modules comprising mediation and a moratorium on creditor action. Australia has attempted to simplify reconstruction and liquidation proceedings, but has not adopted a modular approach of that kind. The Australian approach instead retains the structure of a traditional liquidation or reconstruction, but seeks to reduce the costs involved by lessening the extent of involvement by an insolvency professional and simplifying other steps. We will see that approach has arguably not been sufficiently to address the underlying difficulties in liquidations and restructurings of MSMEs.

The Australian simplified restructuring process

Australia has sought to address these issues by a "simplified" restructuring process, as an alternative to the Australian voluntary administration regime, and a simplified liquidation regime. The simplified restructuring process reflects recommendations made in 2017 but was introduced by the *Corporations Amendment (Corporate Insolvency Reforms) Act* 2020 and took effect from 1 January 2021, during the COVID 19 pandemic. This approach draws on the "debtor in possession" model adopted in the United States and has some similarities to the moratorium regime introduced in the United Kingdom by the *Corporate Insolvency and Governance Act* 2020 (UK) and to the company voluntary arrangement procedure in the United Kingdom.

A company may appoint a small business restructuring practitioner and enter this regime if the eligibility criteria for the restructuring based on the company's liabilities, specified as AUD $1 million, are satisfied and the company's board resolves that it

[6] Davis, pp 29-31.
[7] Davis, pp 48-49.
[8] Davis, pp 63, 86.

has reasonable grounds for suspecting that it is or is likely to become insolvent at a future time and that a small business restructuring practitioner should be appointed. The eligibility criteria include a limitation on the same directors' capacity to use the restructuring plan process more than once every seven years. The simplified restructuring regime allows the company's directors to retain control of the company and business, with the benefit of a moratorium on enforcement by creditors, while a restructuring plan is developed within a 20 business day period and put to creditors for approval. This is likely a real advantage for company management and reduces the costs of a successful restructuring.

The simplified restructuring regime reduces the level of involvement of an insolvency practitioner in the restructuring. Rather than having the conduct of the company's business as in a standard voluntary administration, the insolvency practitioner's role in a simplified restructuring is limited to assisting the directors of the MSME in developing the restructuring plan and a certification role in respect of the information provided to creditors who will vote on a restructuring transaction.

However, that leaves two fundamental difficulties:

- How is the restructuring practitioner to be paid for his or her involvement, particularly if the MSME has delayed taking the necessary steps towards restructuring until after it is already insolvent and there are no assets left to fund his or her remuneration? Typically, a restructuring practitioner will only accept appointment in a restructuring if third parties such as the company's directors or shareholders advance funds for his or her remuneration.
- A restructuring practitioner is exposed to a potential liability risk to creditors in certifying information provided to them and will not undertake that role if not adequately remunerated for it, and may consider the liability risks of the simplified regime are greater than the risks of the standard voluntary administration regime where they have control of the company.

Australia has not established a public authority which either generally funds work done by insolvency practitioners in MSME restructurings, or itself provide oversight of MSME restructurings. There is a strong argument that public funding provides the only real solution to the scarcity of resources which will otherwise lead insolvency practitioners to be reluctant to be involved in MSME restructurings. However, it is understandable that Governments in both developed and developing countries, faced with scarce resources and many demands on them, are not prepared to devote funding to that purpose.

The simplified regime also omits the requirement for creditors' meetings and provides for electronic voting on a restructuring plan by creditors. If a restructuring plan under that regime is proposed but rejected by creditors, the restructuring process ends, and the company can then seek to use alternative insolvency processes such as voluntary administration or liquidation.

A company can only proceed under the simplified restructuring regime if lodges any outstanding tax returns and pays employee entitlements by the time a restructuring proposal is made to creditors. The regime will not be available if the company does

not have adequate financial information to make such lodgements or sufficient funds to pay employee entitlements. This limitation involves another trade-off, since non-compliance with taxation obligations is commonplace in companies that are in financial difficulty in Australia. However, there is an argument that access to a regime which reduces the level of investigation and reporting to creditors by the insolvency practitioner should not be made available to companies that are not substantially compliant with taxation requirements, at least by the time the restructuring proposal is to be put to creditors.

In a report published in January 2023[9] the Australian corporate regulator, the Australian Securities and Investments Commission ("ASIC") reviewed experience under the simplified restructuring process since its introduction in January 2021. ASIC noted there had been 82 appointments of insolvency practitioners to small business restructurings over the 18 months from 1 January 2021 to 30 June 2022, which is a relatively small number of appointments by contrast with the number of voluntary administrations which would have occurred in that period. ASIC recognised the take-up of the regime had been "slow" and noted the possibilities that:

- the eligibility threshold of $1 million of debts may be too low;
- the requirement as to substantial compliance with taxation obligations, at least by the point a restructuring proposal was put to creditors, may prevent companies accessing the process;
- the limited use of the regime may also reflect its complexity, concerns as to insurance cover when a restructuring practitioner is appointed and the possibility that any licences required to operate a business, such as a builder's licence, may be terminated by the appointment of a restructuring practitioner.

ASIC also noted that, of the 82 appointments in that period, 78 restructuring proposals were sent to creditors and 72 companies transitioned to restructuring plans which is an apparently strong success rate. Ten appointments were terminated because the company was not eligible for the small business restructuring regime, or creditors rejected the proposed restructuring plan or the company's directors terminated the appointment of the restructuring practitioner. About two-thirds of the companies that achieved creditors" approval of restructuring plan continued to operate their business. ASIC also noted that the Australian Taxation Office was a creditor of nearly 90% of the companies which entered a restructuring plan and was the major creditor in nearly 80% of those companies. The average return to creditors in the restructurings was 16.2 cents in the dollar, at least partly funded by from contributions by directors or a commitment to make payments from anticipated future trading profits.

A further report into the Australian insolvency regime prepared by the Parliamentary Joint Committee on Corporations and Financial Services in mid-2023 noted some increase in the usage of small business restructuring regime in the period since

[9] Australian Securities and Investments Commission, Report 756, *Review of Small Business Restructuring Process*, January 2023.

ASIC's earlier report, with about 70 restructuring plans put forward in each of the last quarter of 2022 and the first quarter of 2023. The submissions to the Committee again noted a concern that the regime was too complex, although the Australian Taxation Office supported it as providing a relatively straightforward means to approve a restructuring plan and improving certainty about outcomes. The submissions also expressed concerns that many businesses had debts that exceeded the threshold of the regime (but they are arguably not MSMEs) and that some businesses were unable to comply with taxation lodgement applications or pay employee entitlements by the time the restructuring plan is proposed.

Simplified liquidation regime

At the same time as introducing a new debt restructuring process, the Government introduced a simplified form of liquidation for businesses with liabilities of less than AUD$1 million also to commence from 1 January 2021, which is also less commonly used than the standard liquidation regime. The simplified liquidation process is only available in a creditors' voluntary liquidation, and not in a member's voluntary winding up or a winding up ordered by the Court. The simplified liquidation regime limits the circumstances in which unfair preferences can be recovered from creditors not related to the company; narrows the requirement for a liquidator to report potential misconduct to ASIC; removes requirements to call creditors' meetings and establish a committee of inspection; simplifies dividend and proof of debt processes; and increases use of electronic voting and communications. The decision whether to adopt a simplified liquidation process in a creditors' voluntary winding up is made by the liquidator rather than by the company's directors.

The Parliamentary Committee report in mid-2003 also considered the simplified liquidation regime and noted that it had been used in 59 liquidations from January 2021 to the end of September 2022, again a low level of usage. Several submissions to the Committee expressed the view that the simplified liquidation regime was not significantly less complex, less costly or more efficient than the standard liquidation regime, but allowed a shorter time for completion of the liquidation, with the implication that insolvency practitioners would generally not choose the simplified liquidation regime in preference to the standard regime. One submission again raised the alternative of an administrative procedure conducted by or under supervision of or with funding provided by a public authority, but I have pointed above to the Australian government's apparent lack of interest in itself funding simplified restructurings or simplified liquidations.

Implications

The Australian experience of the simplified restructuring and simplified liquidation regimes potentially highlights a wider difficulty. The lesson of this experience is arguably that either radical simplification and public funding of any insolvency practitioner involvement is required or a public body is required to supervise an MSME restructuring process; or it is necessary to take more radical steps to limit the involvement of insolvency practitioners in simplified restructurings for MSMEs, possibly leaving a company or its directors to deal directly with creditors, likely with

some form of oversight needed. Arguably, a modest compromise proposal of the kind that Australia has adopted will have limited practical success.