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What is the role of solicitors in the formal restructuring of insolvent SMEs?

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The Coronavirus economic meltdown has already led to some quick changes to Australian bankruptcy and insolvency law.[1] However, as the basic tools for dealing with insolvency remain the same, it is worth looking at the general regulatory landscape and asking, what is the role of lawyers? And what should that role be?

Introduction

The existing mechanisms in Australia for the formal restructuring of insolvent small-to-medium sized enterprises (SMEs) are not fit-for-purpose and provide few benefits for SMEs, creditors or the broader economy. The principal formal restructuring process, voluntary administration,[2] has an extremely poor success rate: in most cases the return for creditors is lousy and the business is wound up anyway. The other formal re-structuring process in Australia, a court-supervised 'scheme of arrangement',[3] is time-consuming and too expensive to be utilised by SMEs.

In this piece, I suggest that solicitors have an important role in formal restructuring. Unlike other advisers they are better positioned to be a true fiduciary who acts as an advocate for business owners and casts a critical eye upon formal restructuring proposals.

The standard insolvent SME that consults a solicitor

The typical insolvent SME that seeks advice from its accountant or solicitor is small and has limited assets on its balance sheet. The latest statistics regarding typical company liquidations are:

- Employees: 78% of SMEs have fewer than 20 and 62% have 5 or fewer
- Total assets: 78% of SMEs have $50,000 or less and 85% have $100,000 or less
- Total debts: 62% owe less than $250,000 to unsecured creditors
- Books and records: 45% have adequate books and records
- Estimated returns to creditors: 92% produce no return to unsecured creditors.[4]

These statistics paint a sorry picture: on wind-up, nearly half of SMEs demonstrate poor financial management and the majority have few assets. And while they owe moderate amounts of debt, most unsecured creditors get zilch. Many of these businesses might have been saved, but the formal insolvency and restructuring regime has not facilitated this outcome.

Voluntary administration success rates are very low

In voluntary administration, an independent professional is appointed to take control of the company from the directors and to facilitate creditor agreement on a 'Deed of Company Arrangement' or 'DOCA'. The Productivity Commission's 2015 Report[5] on insolvency reform

[1] The Coronavirus Economic Response Package Omnibus Act 2020 temporarily increased the minimum amount required for a creditor to issue a statutory demand for payment of debt (a common precursor to winding-up proceedings) from $2,000 to $20,000 and extended the permissible response period from 21 days to six months.

[2] This process is enabled under sections 436A-436C of the Corporations Act 2001 (Cth).

[3] See Part 5.1 of the Corporations Act 2001.

[4] These statistics were compiled by Professor Jason Harris from ASIC Report 647 for FY18-19 (released Dec 2019), for a Presentation delivered on 12 March 2020 to the NSW Law Society Insolvency Masterclass.

[5] Productivity Commission (2015). *Business Set-up, Transfer and Closure*, Final Report 75, Canberra.

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found that the current insolvency regime does not effectively promote formal restructuring due to the high failure rate of voluntary administration. Only 13% of insolvent companies appoint voluntary administrators and, of those, the prospects of a successful DOCA are very low.

Recent research by Professor Jason Harris found that, over a long-range sample, 29% of administrations entered into a DOCA.[6] The percentage of successful DOCAs that delivered long term trading enterprises is unknown, but believed by the author to be low and something in the order of 25%.[7]

The depressing probability of a successful Voluntary Administration can be broken down as follows:

- Insolvent companies utilising Voluntary Administration (13%), multiplied by
- estimate of DOCAs being approved by creditors (29%), multiplied by
- estimate of successful DOCAs (25%).

The resultant insolvent companies successfully restructuring through voluntary administration? 1%.

Partly because of the poor success rates of the procedure, lawyers and the wider public see the voluntary administration process as a “glorified liquidation”, rather than a robust formal process for restructuring.

This is quite different to the perception of the ‘Chapter 11’ procedure in the United States (US) and other debtor-in-possession regimes around the world. In the Chapter 11 process:

- The Court supervises the company’s attempt to negotiate a plan to re-organise the business;
- The existing debtor remains in control of the business;
- There is a moratorium on creditor proceedings against the debtor company;
- Financing and loans can be acquired on favourable terms by giving new lenders first priority on earnings;
- With the Court’s permission, the company is allowed to reject or cancel contracts.

Chapter 11 does not seem to carry the same stigma with businesses, lawyers or the general public as voluntary administration does. One commentator, Professor Nathalie Martin, suggested that “in fact, in some industries, like the high-tech or dot-com industries, going through a business failure actually can be seen as a badge of honor, proof that the entrepreneurs were willing to take the kinds of risks necessary to fuel capitalism”.[8]

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[6] Presentation delivered by Professor Harris 12 March 2020, Law Society Insolvency Masterclass – PhD Thesis expected to be published by the end of 2020.

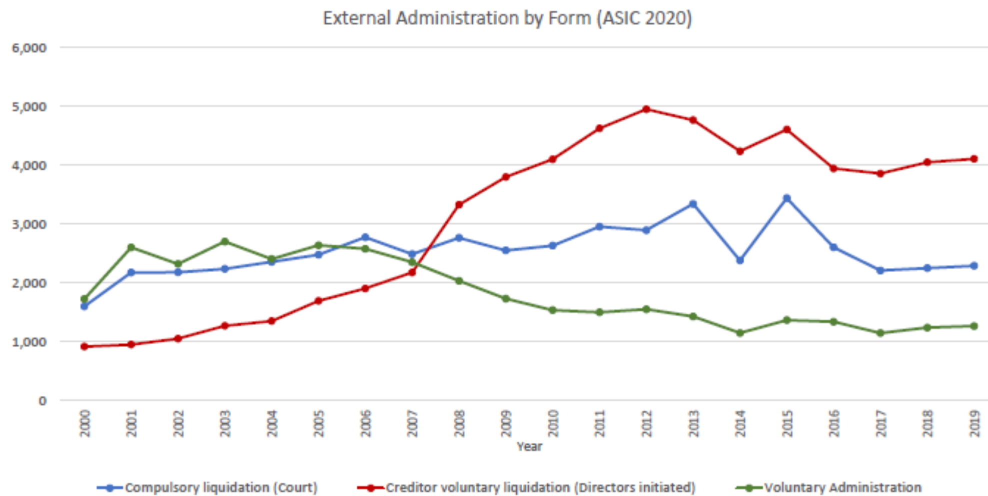
[7] The best empirical information available here is Wellard, Mark Norman (2014). “*A sample review of* Deeds of Company Arrangement under Part 5.3A of the Corporations Act”. ARITA Terry Taylor Scholarship. Australian Restructuring Insolvency and Turnaround Association.

[8] “Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation” (2005) 28 *Boston College International and Comparative Law Review* 1.

Move away from voluntary administration to immediate liquidation

Voluntary administration started in 1993 as an innovative alternative to liquidation and receivership. Over the last 20 years, however, the popularity of the mechanism has deteriorated sharply.

Voluntary liquidation up and voluntary administration down for SMEs



The above chart shows the inversion of the use of voluntary liquidation by directors (Creditors Voluntary Liquidations of ‘CVLs’), and voluntary administration over the last 20 years. What has caused this? The likely contributors include:

- phoenix activity – the often illegal practice of transferring business assets into a new company for less-than-market consideration;
- high rates of failure of voluntary administration; and
- the streamlining of CVL appointments by directors.

The reality is that many appear to have given up on voluntary administration as a useful mechanism for the formal restructuring of SMEs. Aside from the reputational effects of going into voluntary administration in Australia, creditors are aware that they are unlikely to get a return so will often use their power to vote down a restructure (i.e. they are ‘out of the money’).

The role of lawyers isn’t defined

Given that lawyers, perhaps, have good reason not to be involved in voluntary administration, what role might they play in the insolvency process?

Insolvency practitioners have a clear mandate for their role and obligation to maintain independence.[9] They can properly advise directors of insolvent SMEs that they are illegally

[9] For more information see ASIC (2017). “Independence of external administrators: A guide for creditors”. Available at https://asic.gov.au/regulatory-resources/insolvency/insolvency-for-creditors/independence-of-external-administrators-a-guide-for-creditors/.

trading whilst insolvent and that the insolvency practitioner can take an appointment as voluntary administration commences formal restructuring.

Unfortunately, the role of lawyers in an insolvency or potential insolvency is not so easily defined. Added to this is a tendency of lawyers to feel uncomfortable in providing advice with an element of financial calculation.

There is an opportunity for lawyers to assert themselves in the pre-insolvency role. Their possession of legal professional privilege, duties to clients and established role as a trusted advocate, place them in good stead to advise company directors. The insolvency practitioner, by contrast, lacks those duties and privileges toward company directors. They have no legal duty of disclosure or other duties towards the directors such as duties to avoid conflicts and act in the client's interests.

Furthermore, if an insolvency practitioner takes a formal appointment, their duty may be to investigate, report and commence litigation against the directors. It is therefore impossible for an insolvency practitioner to act as a fiduciary for the directors.

The stigma associated with insolvency in Australia

The Productivity Commission found in 2015 that there was an industry-wide view that Australia lacks a turnaround culture.[10] The author's view is that this has created a 'Darwinist mentality' in corporate insolvency that ignores the needs of SMEs. Rather than encourage SMEs towards compliance and viability, they are pushed into evasion and liquidation.

By contrast, in the United States, the current President has utilised the Chapter 11 insolvency regime four times to restructure his businesses (Trump Taj Mahal in 1991, Trump Plaza Hotel in 1992, Trump Hotels and Casinos Resorts in 2004 and Trump Entertainment Resorts in 2009).[11] President Trump has been able to frame his business experience as being part of a winning mindset ("I've never lost in my life").[12]

Consider the Australian case: it is inconceivable that an Australian politician would be elected to high office when companies they managed had unpaid subcontractors and employees. Liquidation and voluntary administration are both viewed equally as failure and incompetence in Australia. In practice, voluntary administration is not viewed as an opportunity to restructure but a preliminary step in the termination of the life of the business.

A pre-pack insolvency arrangement is a legitimate option – in some cases

The lawyer's ethical and professional obligations are a value proposition. The client can rest assured that the lawyer has provided full disclosure of their fees, that the lawyer is focused on their interests and that their communication has strict protections under the law: there is no ulterior motive other than offering competent advice within the bounds of the law and their ethical obligations.

The current insolvency industry 'bad-guys' are advisers that help clients undertake "phoenix activity". As mentioned, this involves resurrecting a business by transferring its assets from an old company to a new company, for less-than-market-value consideration. To further

[10] Productivity Commission (2015). *Business Set-up, Transfer and Closure: Final Report 75*. Canberra.
[11] www.abi.org, American Bankruptcy Institute blog post 'Examining Donald Trump's Chapter 11 Bankruptcies'.
[12] www.businessinsider.com – quote from article "One quote from Donald Trump may explain why he's a billionaire', by Kathleen Elkins. 17 September 2015.

guard against the undervalued transfer of assets the government has made 'creditor-defeating dispositions' illegal under section 588FDB of the Corporations Act 2001. This means that clumsy or fraudulent restructuring may give rise to criminal and civil claims against directors and their adviser from a future liquidator.

In contrast to illegal phoenix activity, is the pre-pack insolvency arrangement. Under these arrangements there is usually a transfer of assets from an insolvent company to a new company, but it is **for valuable consideration**. This is still legal in Australia and the consideration usually proffered is the future payment of employee entitlements and key supplier debts. The result is likely to be a better result for creditors as a liquidation would likely result in the payment of liquidator fees but would involve no return to creditors.

The tools lacking in a voluntary administration scenario

Unlike many overseas jurisdictions there are no mechanisms in place for insolvent companies that preserve a role for management. In contrast the US's Chapter 11 preserves a role for management through debtor-in-possession financing provisions. Furthermore, there are no mechanisms in place that allow for prepack sales, provide for preferential financing or extended moratoriums. This means that there is less flexibility for formal restructuring in Australia. This is counterproductive as, in this author's opinion, it ultimately pushes SMEs towards phoenix operators who encourage fraud or other illegal activities: for example, hiding assets and destroying books and records so that any pre-liquidation asset transfers are hidden.

The table below compares all of the basic tools for formal restructuring in the US, UK and Australia.[13]

Country	UK	USA	Australia
1. Creditors have unilateral rights to seek court protection or appoint parties to manage the business in default	yes	no	yes
2. There are restrictions (creditor consent or insolvency test) to enter court proceedings	yes	no	yes
3. Officers and directors face liability for operating the business while insolvent	yes	no	yes
4. The debtor continues to manage the firm pending the resolution of the case	no	yes	no
5. Secured creditors can seize their collateral, i.e. there is no "automatic stay"	yes	no	yes
6. Secured creditor rank first in priority (above other creditors such as government or workers)	yes	yes	yes and no
7. The debtor can obtain post-filing super priority credit	no	yes	no
8. There are no provisions for cooperation between domestic and foreign courts for cross-border insolvency cases	yes	yes	yes

The salient points are that, whilst a company is in voluntary administration, it can't borrow and the management of the business is removed. Furthermore, directors can only initiate voluntary administration if they are insolvent. Therefore, the result is usually a chilling effect that is interpreted by the market as the equivalent of a liquidation.

[13] See Altman, Edward & Hotchkiss, Edith & Wang, Wei. (2019). *Corporate Financial Distress, Restructuring, and Bankruptcy: Analyze Leveraged Finance, Distressed Debt, and Bankruptcy*. 10.1002/9781119541929.

The best role of lawyers: rights based advice for SMEs

The professional duties that lawyers hold and the protection of legal professional privilege gives them a unique position to advise in the case of insolvency, relative to accountants or insolvency practitioners. The best role as lawyers is to provide rights-based advice to proprietors of businesses. Unlike other professionals and service providers, lawyers don't (or shouldn't) provide one-size-fits-all products or solutions to a client's situation. Rather, lawyers adapt their advice to the unique situation at hand and are required to consider what is genuinely in the client's best interest.

The key take-aways for lawyers for their role are:

- Lawyers must be critical thinkers – the ability to 'think outside the box' and offer tailored advice is what distinguishes us;
- Lawyers act for proprietors – we give rights-based advice about property and its owners and are protected by legal professional privilege;
- Lawyers advise against fraud and recommend up-to-date financials and the lodgement of tax returns;
- Lawyers undertake due diligence by testing key assumptions such as title to assets before appointment of voluntary administration;
- Lawyers negotiate with stakeholders and insolvency practitioners on behalf of proprietors – they are advocates.

Lawyers can be distinguished from other service providers that assist insolvent SMEs:

- Insolvency practitioners: They are less interested in informal restructuring due to the possibility of a conflict of interest and the possibility of being scrutinised in future for pre-appointment advice given.
- Private practice accountants: They are usually the first port-of-call for struggling businesses, but their business model makes it more difficult to offer tailored advice. As they have 100 other clients, like dentists, they are more likely to focus on the wealthiest clients, rather than those in the worst financial position. They may see insolvent clients as time-consuming and have limited opportunity to delegate tasks.
- Phoenix operators: They use fraud and dishonesty as their methodology and are not reliable fiduciaries. Insolvent SMEs cannot count on a phoenix operator to act in their interests.

Root cause analysis – get out of the ivory tower

In order to serve their clients, lawyers need to be able to talk about and analyse the root causes of client insolvency. When the media report SME insolvency, the most common cause referred to is 'poor cash flow'. This is incorrect, poor cashflow is a *symptom* - not a *cause* of insolvency.

The well-known causes of insolvency are sometimes divided into primary and supporting factors[14]:

Primary factors of insolvency:

- Poor management. In too many cases the directors, owners and managers of SMEs are driving the trucks or laying the bricks. They are not devoting

[14] See Argenti, J. (1976).*Corporate Collapse The Causes and Symptoms*. Holsted Press, McGraw-Hill, London.

sufficient time (and may not have the expertise, experience or knowledge) to competently manage the business.

- Poor change management. All SMEs face change from time to time. Whether these are regulatory changes, changes in the business environment (e.g. extra competition) or technological changes. These changes can quickly deteriorate margins if businesses are incapable of responding.
- Overtrading. When a business extends itself too far and grows too fast, it can run out of working capital.
- Disproportionate investment in big project. This is a relatively large project without revenue that diverts the attention of managers as well as cash flows.

Supporting factors of insolvency:

- Lack of up-to-date accounting information. If you can't measure it, you can't manage it.
- Poor risk management of predictable events. Some events (like the current pandemic) are difficult to predict, but other events are more likely to occur from time to time, such as a social media catastrophe or an 'anchor' client leaving.
- 'Creative accounting'. Sometimes the business proprietor relies upon a spreadsheet they created for their financials. Perhaps they have been too generous with deductions or optimistic with expected receipts. Without reconciled financial statements, they may mislead themselves about their true financial position.

This author adds that for SMEs (in contrast to large corporations), there is an extra factor to consider. As the business becomes the 'dominion' of the proprietor, their personal problems more heavily impede business operation. Personal difficulties such as depression, substance abuse, relationship breakdown and addiction can affect every facet of the business. It might be surmised that this is one of the reasons why the construction and transport sectors, where owner-operators and gruelling work hours are the norm, have relatively high rates of insolvency.

Conclusion

The key existing mechanism for formally restructuring a company in Australia do not work. Very few voluntary administrations result in the business continuing. This means that informal restructuring mechanisms, such as pre-pack insolvency arrangements, are the best bet for the survival of SMEs.

Lawyers have tended not to assert themselves in this process. But they should. Their fiduciary duties, legal professional privilege and client/proprietor-focused approach makes them well-suited to this task.