UNCCA

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A simplified insolvency regime tailored to the needs of small debtors

or

The insolvency of micro, small and medium-sized enterprises (MSMEs)

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The insolvency of MSMEs raises particular issue across jurisdictions where insolvency laws are generally focused on larger enterprises involving procedural complexity and cost and where the particular issues raises by MSMEs are not adequately addressed.

UNCITRAL had earlier asked Working Group V to offer a range of new and simplified mechanisms for MSME insolvency that take into account the need for them to be "equitable, fast, flexible and cost efficient". In proceeding to work on this request, WGV decided that it was not necessary to await the outcome of work being done by Working Group I (MSMEs) on alternative structures for small business, although they may intersect at a later date.

A draft text has been prepared for the next meeting of WGV to which this commentary[1] refers.

As the text explains, the importance of the topic lies in the recognition of the impact of MSME insolvency on

"job preservation, the supply chain, entrepreneurship and the economic and social welfare of society".

UNCITRAL also notes the

"growing recognition of the negative consequences of unresolved financial difficulties for micro and small business debtors that, burdened by old debt, may be discouraged from taking new risks or become trapped in a cycle of debt or driven to the informal sector of the economy".

Others[2] have pointed out that in virtually all global economies, MSMEs are a primary means by which entrepreneurs bring new business propositions to the market and deliver a range of products and services to local economies. But they tend to be more reliant on favourable legal and regulatory climates to survive and thrive than larger businesses, and insolvency regimes are not so tailored. Their assets are of less value, and their creditor stakeholders are smaller and less willing to oversight and take part in the process.

WGV has also taken into account the World Bank's *Report on the Treatment of MSME Insolvency*[3] and publications of other international organizations and academic writers.

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[1] *Insolvency of micro, small and medium-sized enterprises, Draft text on a simplified insolvency regime*, Note by the Secretariat, 22 March 2019.

[2] See *Micro, Small, and Medium Enterprise Insolvency - A Modular Approach*, Riz Mokal, Ronald Davis, Alberto Mazzoni, Irit Mevorach, Madam Justice Barbara Romaine, Janis Sarra, Ignacio Tirado and Stephan Madaus, Oxford University Press, 2018.

[3] May 2017.

This presentation offers a broad coverage of the issues involved and the options proposed by WGV.

My QUT colleague Anne Matthew will also examine and explain what is termed a "modular" approach to MSME insolvency, proposed by "seven scholars in six jurisdictions and one member of the Canadian judiciary".[4] Its approach is to address what its originators say is the

> "incongruence between the design of insolvency regimes and the nature of most of the businesses to which they apply [leaving] the insolvency process unbalanced, inadequately supervised, ineffective, and sometimes simply unfeasible". The modular approach "systematically rethinks the treatment of MSME insolvency".[5]

A brief comment is then made on Australia's legal and commercial environment for MSMEs and what features and reform ideas, if any, seek to address their insolvency.

At its meeting from 28-31 May 2019,[6] WGV is to resolve the text and report to the fifty-second session of UNCITRAL in Vienna, in July 2019. The form of any final document has yet to be determined, either as an annex to the UNCITRAL *Legislative Guide on Insolvency Law* (the Guide) or as a stand-alone document.

This is therefore not a cross-border insolvency issue, which less often arises for MSMEs, but one offering a focus on a set of world-wide principles in relation to MSME insolvency to which countries may refer for adoption or adaptation according to their particular needs – their "constitutional, cultural, social and economic norms".

UNCITRAL draft text on a simplified insolvency regime[7]

Reference throughout the draft text is made to the Guide, UNCITRAL acknowledging however that it does not adequately address the range of issues in MSME insolvency.

In that respect, the text notes that the standard business insolvency processes, in particular the central role of the court and the extensive involvement of an insolvency professional, are often not appropriate for MSMEs.

> "That may in particular be the case in insolvency of individual entrepreneurs and micro and small businesses of an essentially individual or family nature with intermingled business and personal debts (collectively referred to in this document as "micro and small business debtors"). Such debtors may be discouraged by standard business insolvency processes because of their length, procedural inflexibility and costs, as well as the inherent risks of loss of control over the business. Micro and small business debtors might prefer less costly, faster and simpler proceedings and those that facilitate a fresh start through discharge".

The text also comments that the provision of confidentiality would alleviate concerns over the social stigma of insolvency.

The key insolvency principles and the guidance in the Guide remain relevant but with some variations.

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[4] See *Micro, Small, and Medium Enterprise Insolvency - A Modular Approach*, fn 2, Preface.

[5] See *Micro, Small, and Medium Enterprise Insolvency - A Modular Approach*, fn 2, p 3.

[6] UNCCA on behalf of Lawasia is being represented by Dr Neil Hannan, and by students Casley Rowan and Xiaoya Liu.

[7] Note by the Secretariat, 22 March 2019.

The idea is there to offer a range of tools, from purely contractual out-of-court debt restructuring negotiations to standard business insolvency proceedings, either by adjusting features of their existing insolvency law or by establishing a separate regime.

"It is for policymakers in each jurisdiction to identify features of such a regime and eligible debtors that might not be served well by the standard business insolvency regime and would thus benefit from access to a simplified insolvency regime".

While the precise definition of MSME is not offered, although there are many criteria used, the text gives a useful overview of MSMEs in these terms, that they are:

"relatively undiversified as regards creditor, supply and client base; as a result, they often face the cash flow problems and higher default risks that follow from the loss of a significant business partner or from late payments by their clients. They also face scarcity of working capital, higher interest rates and larger collateral requirements, which make raising finance, especially in situations of financial distress, difficult, if not impossible.

Access to credit is often made subject to the granting of personal guarantees by the owners or their relatives and friends whose personal assets could be of equal or greater value than that of the small debtor. Owners thus frequently provide not just equity, but also debt funding.[8]

Any physical assets of small debtors, which may be the main or the only assets of the value to creditors, may already be encumbered to secured creditors with "hold-outs" by such creditors being common in the context of negotiating a solution to financial difficulties of the MSME. And unencumbered assets are usually of little or no value. Because the costs of participating in the insolvency proceedings may outweigh the return, those creditors stay disengaged, thus jeopardising reorganization leaving liquidation as the only option.

MSMEs often have poor or non-existent records; there may be no clearly established ownership of key commercial assets; work for the debtor may not be documented or remunerated and the use by the owner of their own funds may not be documented; owners may use their own finances to fund or support the business without necessarily documenting that expenditure.

MSMs are often characterized by a centralized governance with the management unwilling to initiate insolvency protection because of the risk of losing control. They are also prone to adopt more high-risk strategies in attempts to save the business. These factors may contribute to the financial crisis and lead to the debtor addressing financial difficulties too late".

The range of options and issues covered

The range of issues and options discussed are best outlined by reference to a list of the topic headings.

Mechanisms for resolving micro and small business debtors' financial difficulties.

[8] " … the reality is that micro and small businesses ("MSE") cannot get financing for their business unless they can guarantee the debt with their personal assets. Such guarantees effectively blur the distinction between personal and business debt": *Micro, Small and Medium Enterprise (MSME) Insolvency in Canada* Janis P. Sarra, 30 March 2016.

A. Out-of-court debt restructuring negotiations

- General characteristics
- Usual steps in out-of-court debt restructuring negotiations
- Factors that contribute to the success of out-of-court debt restructuring negotiations

B. In-court simplified proceedings

- General characteristics
- Eligibility
- Presumption of good faith
- Commencement standards
- Fees
- Stay

III. Types of in-court simplified insolvency proceedings

- Zero-asset proceedings
- Simplified liquidation
- Expedited proceedings
- Simplified reorganization

IV. Conversion of proceedings

V. Assets constituting the insolvent estate of a micro and small business debtors

VI. Discharge

VII. Special treatment of certain claims and persons

- Small claim creditors
- Secured creditors
- Interim and post-commencement finance
- Personal guarantors
- Related persons

VIII. Coordination of related proceedings

IX. Obligations of managers of micro and small businesses in the period approaching insolvency

X. Relationship with other law and institutional framework

Options within this list being considered by WGV include out of court resolutions and simplified court processes, combined treatment of personal and corporate debt, determination of criteria for access and commencement, operation of stays of creditor actions, a presumption of good faith, “zero-asset proceedings”, “debtor in possession” or “debtor led” models, limited or no involvement of insolvency professionals and the processes of prompt discharge. There may be a focus on the MSME’s liquidation or reorganisation, or both.

Appropriate safeguards against abuse are canvassed. They may involve replacing a debtor with an insolvency representative when there is real or potential abuse, conversion from one

model to another if an initially viable business is then deemed non-viable, and refusing or delaying discharge.

Two separate insolvency regimes may be devised, one for micro and small business debtors and the other for larger enterprises; or a regime that deals with both consumers and micro and small businesses. In that respect, the text also examines the issue from an economics perspective, the focus being on the business itself not its personal or corporate structure.

Many small businesses are sole proprietorships, with some being incorporated – single director companies - and some not – sole traders. How the business is structured will depend on local practice and advice. Incorporation of the micro business often occurs because "someone has advised the individual business person that he or she will better protect his or her personal assets if the business is incorporated", which may well not be the case if personal guarantees and other security is required.[9]

Within these headings are principles offered that include the lowering of the barriers to insolvency proceedings, and encouraging early access; reducing stigma and personal risks; ensuring proceedings are expeditious simple and low cost; and that they support entrepreneurial conduct and business risk while at the same time coupled with the need to protect creditors and mitigate the risks of abuse.

The inherent small size and often limited assets involved are addressed in options involving government funding of MSME insolvency, in the context of a government liquidator or other external assistance; the need to limit costly court involvement, and to limit formal intervention by insolvency practitioners.

The text notes that some jurisdictions simply allow "zero-asset" insolvent companies to be disposed of without examination, which, while financially expeditious, carries with it some attendant potential for abuse. To some extent, this is said to be the case in Australia.

The need for discharge of the debtor is important, and within a reasonable time. The paper notes the international trend towards that time being reduced in many jurisdictions, as is contemplated in Australia's proposed one-year bankruptcy.

Australian domestic MSME insolvency

Reliable information about MSME insolvency in Australia is not much available, a past recommendation that there be an authority established to gather, collate and analyse data for free public access on a range of corporate and personal insolvency matters was rejected.[10]

We have therefore never been able to reach the level of analysis of whether a joint personal/corporate regime for small insolvency might be needed.[11] What information there is being separately maintained by each regulator, ASIC and AFSA. The legal separation between the individual and the company remains firm even in the context of many

[9] *Micro, Small and Medium Enterprise (MSME) Insolvency in Canada* Janis P. Sarra, 30 March 2016
[10] Among other recommendations in *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework*, 14 September 2010.
[11] The Productivity Commission raised it without developing it: see *Business Set-up, Transfer and Closure*, 7 December 2015.

businesses operating through one director companies.[12] The separation in policy and approach between AGD and Treasury is another factor.[13] Each of these impede any examination of the issue, including by the private profession, and academia.

As to what is available, in personal insolvency, revised debt agreement laws commence on 27 June 2019 but the income and assets restrictions do not assist most business debtors. The parallel Bill for a reduction in the period of bankruptcy to one year has not proceeded. One political focus for that reduction was on promoting a more entrepreneurial focus and reducing the stigma of insolvency, both being aspects of focus by WGV.

Australia has the government Official Trustee in Bankruptcy to handle assetless MSMEs along with consumer bankruptcies. The private profession – registered trustees – handle about 15% of all bankruptcies. There is limited if any government input. Creditor returns average under 2%.

The numbers of 'business bankruptcies' stand at 18%[14] there are no figures on the extent to which companies are involved; nor within ASIC's statistics.

In corporate insolvency, there are no specific insolvency laws on MSMEs. A 2015 Productivity Commission Report recommended a streamlined liquidation process for low debt and asset companies,[15] which the government did not pursue.[16]

The government has also raised the idea of a "'government liquidator' to conduct a streamlined external administration of small-to-medium size enterprises with the option to appoint a private registered liquidator if circumstances warranted it",[17] noting that a similar system operates in personal insolvency.[18] Nothing has proceeded.

Hence the private profession – registered liquidators – handle all corporate insolvencies. There is some government funding through ASIC's Assetless Administration Fund. Nevertheless, the private profession is estimated to contribute many millions in unrecovered remuneration.[19] This is despite the 'official liquidator' status and obligations having been removed in 2017.

ASIC reports that 97% of external administrations produce creditor returns of under 11c.[20]

MSME companies tend to be handled by the smaller and cheaper end of the insolvency market, with financial input from directors, less so from creditors; or are processed through unlawful phoenix and other such processes through pre-insolvency advisers.

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[12] Some exceptions are *Why Australia needs new insolvency laws for small businesses*, The Conversation, 29 September 2017, Kevin B Sobel-Read and Madeleine MacKenzie, University of Newcastle. In Canada, see *Micro, Small and Medium Enterprise (MSME) Insolvency in Canada* Janis P. Sarra, 30 March 2016.

[13] *Keay's Insolvency*, 10th ed, LBC, 2018 [1.185]

[14] AFSA, March 2019

[15] It proposed a simplified 'small liquidation' process for companies with liabilities to unrelated parties of less than $250 000. Directors would be required to lodge a verified petition with ASIC. The primary role of the liquidator would be to reasonably ascertain the funds available, with requirements for meetings, reporting and investigations being reduced accordingly: recommendation 15.1.

[16] Government response, May 2017

[17] *Combatting Illegal Phoenixing*, September 2017, Treasury.

[18] It might have also pointed out that in adopting English corporate law, Australia specifically did not follow the English approach of having the Official Receiver appointed to court appointed liquidations: *McPherson's Law of Company Liquidation*, LBC, [1.410].

[19] ARITA claims that "the population of less than 700 liquidators has to write-off some $100 million in unrecoverable fees each year": ARITA submission to ASIC, 26 April 2019.

[20] ASIC Report 596

As to the remaining companies, in particular in the absence of a government liquidator, a concern has been expressed about the large number of companies that 'disappear off the register' – in the tens of thousands - by way of default deregistration – a "likely 'black hole' of director misconduct and unpaid liabilities".[21]

As to creditor returns generally, we know that of over $330 million brought in by registered bankruptcy trustees in 2016-2017, only $57 million reached unsecured creditors, with secured creditors being paid over $93m, and trustee remuneration, government charges, legal and other costs exceeding $150 million. Trustees' court challenges to voidable transactions produced only $12.5 million, and the costs of those recoveries probably accounted for much of that amount.[22]

There are no comparable figures for corporate insolvency.

While Australia would have much to offer UNCITRAL on the topic of MSE insolvency, were it to attend, it also has a lot to consider about its own MSME insolvency regime.

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[21] A "likely 'black hole' of director misconduct and unpaid liabilities": *The Protection of Employee Entitlements in Insolvency - an Australian Perspective*, Professor Helen Anderson, Melbourne University Press, 2014, at p 186. She reports that the statistics kept by ASIC on this are variable in quality and generally not helpful.

[22] *Keay's Insolvency*, pp 28-29 citing AFSA's administration statistics 2016-2017.

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[25] Updated 20 May 2019.