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What is the role of solicitors in the restructuring of insolvent small or medium-sized businesses today?

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People often underestimate how effective solicitors can be in enabling and supporting restructuring mechanisms for small and medium-sized businesses. The perception is that directors will first turn to accountants, insolvency practitioners and financial advisors before solicitors. Here we explain the role that solicitors can and should play in debt restructuring for insolvent businesses in Australia.

The Australian economy is dominated by small business (at 97.3 percent of all businesses). It is therefore no surprise that small businesses make up a large proportion of those businesses that go insolvent in Australia. Insolvency does not have to end in company liquidation and termination, however. There are a range of restructuring options available in Australia, and solicitors can be useful in helping business directors to assess and implement these options.

In this article we explain the unique role that lawyers or solicitors play, and look at how solicitors can be involved in each of the restructuring options available in Australia.

Restructuring Options in Australia

When company directors determine that their company is insolvent, or likely to become so, they are *required* to take action (Read more in ASIC's guide to director duties). If the directors want to try and turn the company around, they need to consider debt restructuring — releasing some of their debt so that they can continue to trade normally. Restructuring in Australia can take several forms. We consider each in turn:

Small business restructuring

This process, (known simply as 'restructuring' in the Corporations Act 2001 (Cth)) is a relatively new process for attempting to quickly turnaround a struggling small business. Businesses will be eligible for this restructuring process where they are insolvent or likely to become so, have liabilities of less than $1 million, are up-to-date

on tax lodgements and employee entitlement payments, and where directors have not previous used this process or simplified liquidation in the past 7 years.

Through small business restructuring, directors of eligible businesses appoint an independent professional, the Restructuring Practitioner, to develop a restructuring plan for the company. While that plan is being developed, the directors stay in control of the company (they are ‘debtors in possession’). At the end of 20 business days a plan is offered to the creditors. If creditors by majority in value accept the plan (they have 15 days to consider it), the plan is implemented and admissible debts extinguished. The company can then continue to trade without the burden of the previous debt.

Voluntary Administration (VA)

This process, as with small business restructuring, is initiated by directors who must first resolve that their company is insolvent or likely to become insolvent. Here, an independent professional, the Voluntary Administrator, is appointed by the directors to develop a debt compromise (a ‘deed of company arrangement’ or ‘DOCA’). If the DOCA accepted by the creditors, the debt is restructured and the company can either continue to trade or go into liquidation. Note, for the duration of the Voluntary Administration process, the Voluntary Administrator takes control of the company from directors and can continue to trade (though for liability reasons, they usually decline to do so). The process takes a couple of months.

As Voluntary Administration does not have a cap on liabilities, businesses who would be ineligible for small business restructuring due to the size of their debt will still be eligible for Voluntary Administration. Note that as creditors of majority in value *and* numbers must agree to the DOCA, this process gives more power to minority creditors than small business restructuring.

Schemes of Arrangement

This is a flexible mechanism in section 411 of the Corporations Act 2001 (Cth) used for a variety of restructuring and reorganization purposes, including capital restructuring and altering corporate structures, as well a debt restructuring. This mechanism does not require that the company be insolvent. Agreement from shareholders is required and the process is supervised by the Court. It is an expensive and usually time-consuming process, so is generally only used for the largest of companies in Australia.

Pre-packs

A ‘Pre-packaged insolvency arrangement’ or ‘pre-pack’ involves directors arranging for the sale of assets from the old (potentially insolvent) company to a new company for fair market value. At the same time, any employees of the old company may be transferred to the new company in preservation of their original entitlements. Once the sale is agreed to by the purchaser, a Voluntary Administrator or Liquidator is appointed. If the Voluntary Administrator or Liquidator concurs that this sale gives creditors a better return than they would otherwise get, they will approve of the sale

and wind up the company. The business can then continue to trade through the new company structure.

This option is particularly popular in the UK, and, while less popular, is permitted in Australia under 'safe harbour' provision in section 588GA of the Corporations Act 2001 (Cth). This provision means that directors are not liable for permitting the company to trade while insolvent as long as they meet certain conditions and are "developing a plan reasonably likely to lead to a better outcome for the company". To read more about implementing a pre-pack correctly read our guide on what *not* to do when choosing a pre-pack.

The Special Role of Solicitors: Rights-based advice for SMEs

No matter which restructuring option is chosen, the professional duties and legal professional privilege that lawyers hold gives them a unique position to advise in the case of insolvency, relative to accountants or insolvency practitioners. The role of 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 them;
- **Lawyers act for proprietors** – they give rights-based advice about property and its owners and are protected by legal professional privilege. They are also fiduciaries, bound by law and our professional obligations to be loyal to director clients and act in their interests;
- **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 administrators;
- **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 they are more likely to focus on the wealthiest (and most stable) 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.

Below we consider the role that solicitors can play in restructuring in general, and in each specific type of restructuring.

The Role of Solicitors in Pre-Appointment Advice

Insolvency practitioners (being registered liquidators) have a clear mandate for their role in restructuring in Australia and an obligation to maintain independence. They can properly advise directors of insolvent SMEs that they are illegally trading whilst insolvent, and that the insolvency practitioner can take a voluntary administration or restructuring appointment to commence 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 directors such as avoiding conflicts and acting 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.

The Potential Solicitor Role in Voluntary Administration

The most important role that a solicitor can play in Voluntary Administration is providing pre-appointment advice. As alluded to earlier, Voluntary Administrators have no fiduciary obligation to directors, and are often reluctant to give advice prior to appointment as this may undermine their independence. The solicitor can provide guidance on the consequences of not going into Voluntary Administration (including possible liability for allowing insolvent trading to occur), and help directors understand the implications of Voluntary Administration on the company's operations and their personal liabilities. They can discuss the implications of other restructuring options, and where necessary or viable, negotiate and enter into settlements with creditors.

Once the Voluntary Administration is under way, solicitors can advise on:

- **Ensuring compliant documentation and processes**. They can review DOCAs and other contracts associated with a debt compromise to ensure that a director's interests are protected as far as possible.
- **Disputes with the Voluntary Administrator**. A solicitor can engage with the Voluntary Administrator on any matters of disagreement. If litigation against a Voluntary Administrator is required, the solicitor can represent the director in Court.
- **The entitlements of creditors**. This will be particularly important to directors where they themselves are creditors (as is often the case). Solicitors can advise on the implications for a creditor's rights and entitlements in accepting a DOCA.

The Potential Role of a Solicitor in Restructuring (Small Business Restructuring)

As in Voluntary Administration, the solicitor can play a pivotal role, prior to a Restructuring Practitioner being appointed. Solicitors can advise directors on eligibility criteria for small business restructuring, their duties and responsibilities throughout the process, and the potential consequences. For example, they can advise on the director's ongoing liability if the company continues to trade throughout the restructuring process, and what happens if creditors do not agree to the restructuring plan.

In addition they can support directors by:

- **Ensuring a compliant restructuring process**. The solicitor can review any Restructuring Plan to advise on its implications for directors.
- **Advocating in disputes** with the Restructuring Practitioner. A solicitor can represent the director on any matters of disagreement with the restructuring practitioner. If litigation follows, the solicitor can represent the director.
- **The entitlements of creditors**. Where the directors are themselves creditors, solicitors can advise on the implications for a creditor's rights and entitlements in accepting a Restructuring Plan.

The Potential Role of a Solicitor in a Pre-Pack

With respect to a pre-pack, a solicitor can support the process through:

- **Advice on the viability of a pre-pack**. Solicitors can advise on whether a proposed pre-pack can be developed under the safe harbour provisions in the Corporations Act 2001 (Cth), or whether there is a risk of liability for insolvent trading.
- **Drafting sales agreements**. Solicitors can ensure that once a seller is identified, a sales agreement is drafted which, as much as possible, protects the interests of directors and is still in compliance with the Corporations Act

2001 (Cth). For example, a solicitor can advise on whether the sale could constitute a 'creditor-defeating disposition'/illegal phoenix activity.

- **Transfer of assets and liabilities**. Solicitors can prepare documentation (such as new employment agreements) for the transfer of any employees to the new entity.

A solicitor is of particular value in a pre-pack as the Voluntary Administrator or Liquidator that is appointed to approve of the pre-pack cannot give pre-pack advice (as that would be a conflict of interest). In general, insolvency practitioners would prefer a formal appointment than providing pre-appointment advice.

Conclusion — the Role of Solicitors in Restructuring

Most small business directors do not work closely with solicitors — and where they do, those solicitors are likely to do general commercial transactions, rather than being restructuring experts. Small business directors are more likely to work with accountants, and where they get into financial difficulty, perhaps referred on to general financial advisors who specialise in insolvency. However lawyers who specialise in restructuring and insolvency can greatly benefit insolvent small and m