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PRE-PACKS & PHOENIXING

EXECUTIVE SUMMARY

The legislative reform you propose is great for large scale phoenix activity.

But I respectfully suggest it will do little to change the landscape in the SME market where the vast majority of illegal phoenix activity occurs.

Australia has a great statutory framework for large scale insolvencies but the transaction costs of recovering voidable transactions and prosecuting a breach of director duties in the SME market renders our laws obsolete.

Your legislative reforms would be enhanced by following:

1. Reverse the onus of proof.
2. Introduce a guide on how to legitimately phoenix a SME.

In respect of the later it is critical to recognise that about 90% of liquidations have less than 100K in assets.

To be effective, your reforms should target this SME market but they do not.

Prepacks are the cheapest way to save a business from insolvency.

They are about 50% cheaper than a voluntary administration; and 25% cheaper than a normal liquidation.

The UK prepack framework is a 3 page regulatory guide. It is not a statutory framework.

Professor Richard Fisher was a co author of the VA framework, and author of the Bankruptcy Act's Part IX. I recently provided research assistance to Mr Fisher when he published his prepack framework for Australia.

I attach his framework for your consideration.

I note that Ron Harmer, was also a co author of the VA framework, and he was also collaborating with me prior to his passing. Mr Harmer also supported the implementation of prepacks in Australia.

The productivity commission supported my submission that ASIC should issue a guide on how to save a SME, it suggested the prepack framework was preferable.

If insolvent SME companies were encouraged to sell their assets via a formal process, controlled by a liquidator, who puts their registration on the line, market value for the assets will in the normal course be achieved. This will materially reduce illegal phoenix conduct.

Prepacks provide a framework and can materially reduce illegal phoenix conduct.

I encourage you to adopt Mr Fishers framework as part of your legislative reform, if only as a guide in the first instance.

SAVING A BUSINESS V'S SAVING A COMPANY

Prepacks save a business from ceasing to trade, but the company fails and goes into liquidation. The company is insolvent and can not be saved. Most company's that use a prepack, in the UK, are too small to afford Administration, and have not option but to liquidate.

The business is saved and jobs retained by selling the business to a new company via a prepack.

COST SAVINGS

A voluntary administration costs on average $83K in Australia.

The company and business can be saved, via the compromise of creditor claims who generally get 5 cents in the dollar (via a deed of company arrangement).

The material costs are:
Trade on costs,
Statutory compliance
Creditor meetings x 2
Creditor Reports x 2

An insolvent business, can also be sold, and the business saved by a liquidator selling the business. The costs are materially less because there is less meetings and less reporting obligations than a voluntary administration. But the process remains very expensive.

Prepacks are the cheapest option to sell an insolvent business, because the insolvency practitioner can avoid all personal obligations of a trade on and instruct the director to undertake the hack work of a sale.

The insolvency practitioner can effectively act as a consultant and make the director and his staff do the work, rather than insolvency practitioners at $600 a hour in formal administrations.

Pre-packs enable a director to legitimately move an insolvent business into a new company shell and start again without having to pay existing creditors.

The United Kingdom Government's enquiry into pre-packs reported 2 out of 3 pre-pack sales are to new shell companies set up by the existing company directors and about 60% defer consideration for the assets purchased.

PRE- PACK DEFINITION

A pre-pack can be defined as:

> *A process of arranging the sale of a company's business before the formal appointment of a liquidator, who will finalise the sale as soon as possible after their appointment.*

Pre-packs are used in the following countries to help small companies restructure: the UK, Germany, France, the Netherlands, Belgium, Italy and the Czech Republic.

A variation of the pre-pack model is also used in the US. The most famous example was the General Motors restructure. A company called New GM Inc paid $50 billion for the assets from the insolvent GM Inc. The deal took 30 days to put together and was funded by the US Government. It's a great example of a successful phoenix saving about 200,000 jobs.

In 2014, a British Government review into pre-packs drew the following conclusions:

- About 25 per cent of all companies that go into administration in the UK each year (about 750 companies) implement a pre-pack;
- 96 per cent of pre-packs save jobs;
- Pre-packs are at least 50 per cent cheaper than a traditional administration;
- About 77 per cent of pre-pack sales in the UK are small companies (i.e. companies with fewer than 10 staff and a turnover of less than £1 million);
- The average purchase price of UK pre-pack sales in the UK is £54,000 (about $110,000).

For more details, see Graham Review into Pre-pack [hyperlink: https://www.gov.uk/government/publications/graham-review-into-pre-pack-College administration].

About 53 per cent of pre-pack sales in the UK use deferred consideration as a means to pay for assets subject to pre-packs. In two-thirds of these sales the new company will give security (a mortgage or security interest) to the insolvent old company to ensure the rights of its creditors are protected.

A British Government report into pre-packs concluded:

> *"Old company creditors are not unduly harmed by the presence of deferred consideration in a pre-pack deal."*

VOLUNTARY ADMINISTRATION OR PRE-PACK?

The voluntary administration (VA) framework is a world-class statutory framework, but the administrator's fees and trade-on costs are prohibitive for most small businesses to successfully use it to guide them out of financial distress.

In Australia only about 5 per cent of the 10,000 companies that enter into a formal insolvency administration each year will use this framework to successfully restructure.

Typically the lucky 5 per cent are large companies with enough money to pay the administrator's fees and trade-on costs.

In our experience, it is impossible for the majority of insolvent small companies to use the VA framework to restructure. The following background information supports this view.

Figures from a 2013 ARITA report:

- The average cost of a VA was $54,670
- The average cost of a deed of company arrangement $28,772
- Total professional fees came to $83,442

- The average dividend paid to creditors was 5.5 cents.

More from the ASIC Report 412 Insolvency Statistics to June 2014, Table 30:

- 80 per cent of all corporate failures have fewer than 25 creditors
- 75 per cent of all corporate failures owe less than $500,000 to creditors.

Various ASIC annual reports show 93 per cent of liquidations do not pay any dividend.

In short, in 75 per cent of the 10,000 companies that go broke each year, there is simply no money left. The mums and dads who own these 7500 SMEs don't even have the money to keep trading, let alone a spare $83,000 to pay an administrator.

Without at least $83,000 in cash or liquid assets, an insolvent business will usually be shut down and will not survive the voluntary administration process.

Voluntary administration remains a wonderful framework to restructure companies that have the resources to pay for administration costs. Everybody else should be restructured via a pre-pack or post liquidation sale of assets.

PRE-PACK HISTORY

Since the introduction of the concept of trading via a company in the 1800s people have purchased the assets from the wreckage of failed companies and used those assets to trade in new company shells. The voluntary administration framework is merely a variation of this practice of recycling or "phoenixing" assets into a new cleanskin company. Pre-packs are the latest variation of this process.

Pre-packs were developed in the UK about 15 years ago and do not rely upon a statutory framework. They were developed from common practice, judicial support and a statement of best practice (SIP 16) issued by the professional bodies that practice insolvency.

THE UK'S PRE-PACK EXPERIENCE

About 50 to 100 pre-packs or legitimate phoenix sales are undertaken in the UK each month. The UK's Government Insolvency Service (the counterpart to our AFSA) has stated:

> *"A pre-pack may offer the best chance for a business to be rescued, preserve goodwill and employment, maximise realisations and generally speed up the insolvency process."*

The insolvency regulatory bodies in the UK have issued a guidance note that sets out the basic principles and essential procedures insolvency practitioners must comply with when they undertake a pre-pack. (That's right, the UK government has sanctioned pre-pack sales or legal phoenix sales and issued a guidance note to accountants and lawyers to assist them in undertaking pre-packs.)

Statement of Insolvency Practice 16 has been adopted by each of the UK's professional bodies, including:

- The Association of Chartered Certified Accountants
- The Insolvency Practitioners Association
- The Institute of Chartered Accountants in England and Wales
- The Institute of Chartered Accountants in Ireland
- The Institute of Chartered Accountants of Scotland
- The Law Society

- The Law Society of Scotland.

The website of the UK Attorney General states:

> *"It is perfectly legal to form a new company from the remains of a failed company. Any director of a failed company can become a director of a new company."*

PRE-PACK STATISTICS

Research into the pre-pack process in the UK is summarised below:

Particulars	Pre-pack sale	Insolvency sale
All employees transferred to new company	96%	65%
Secured creditor return	42%	28%
Average return (unsecured creditors)	1%	3%
Sale of assets to related party	64%	52%

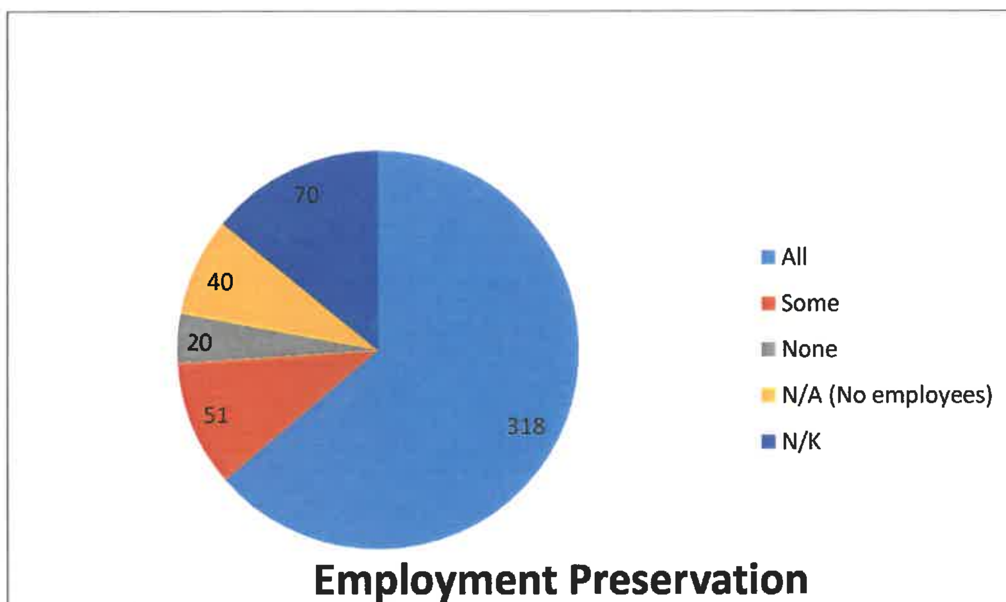
Source: Frisby SA "Preliminary analysis of pre-packed administrations" 2007 https://www.r3.org.uk Amended for the Graham Review findings.

The key statistic from this table is this: 52 per cent of all insolvency sales by liquidators in the UK involve a sale of some assets to a related party.

PRE-PACKS SAVE JOBS

Statistics we obtained from ASIC on behalf of Senator Williams in 2010 showed that only 4 per cent of the 10,000 companies that go broke each year in Australia will complete their obligations under a deed of company arrangement (VA). That is, only 4 per cent of all insolvent companies will successfully restructure using the VA framework.

In the UK, by contrast, pre-packs have a 96 per cent success rate of preserving existing employee jobs, according to the UK Government's Graham Review. (See page 25 of the report; note only 20 of the 499 pre-packs in the sample failed to retain staff and most of these were cases where the business was shut down before a liquidator was engaged.)



If saving jobs is the yardstick for determining if insolvency laws help a business, that's a 4 per cent success rate for the Australian voluntary administration framework and a 4 per cent failure rate in the UK's pre-packs.

ONLY SMALL BUSINESSES USE PRE-PACKS
Page 26 of the UK Government's review into pre-packs indicates that the vast majority of pre-packs are used by companies that have less than $110,000 in assets.

I respectfully submit, this is the target market that your legislative reforms should be focused.

RELATED PARTY PURCHASES
In the UK, about 64 per cent of all assets and businesses sold via a pre-pack are sales to related parties.

In Australia, there is no statutory prohibition on a director or a related party purchasing the business or assets of an insolvent company. In addition, there is a common misconception that any sale of a business to an existing director or related party is always an illegal "phoenix".

In fact, related party sales are common in Australia, but directors should seek professional advice to be sure they discharge their statutory and fiduciary obligations when they purchase an asset or business from their company.

In our experience, the most important asset of any small business is its staff, the "key people" and existing management who know how to run the business.

For this reason, most small companies' insolvent businesses are purchased by staff and related parties. The existing directors, shareholders and staff know the value of the insolvent business, the good and bad suppliers and the potential value of the location, goods and services sold.

PRODUCTIVITY COMMISSION
In 2015, the Federal Government's Productivity Commission undertook the most comprehensive review of insolvency industry in the past 20 years. The Productivity Commission stated:

> *"Crouch Amirbeaggi suggested an Australian hybrid model [for restructuring insolvent companies] that could avoids costs, assuage creditors' concerns and presents small to medium enterprises with a genuine option for restructure."*

Recommendation 15.7 invites ASIC to introduce a Regulatory Guide on prepacks to assist small business owners who cannot afford to use a VA to save their insolvent small business.

I encourage you to provide a framework so SME owners have a guide on how to legitimately save their business where a VA is not viable. This will materially reduce illegal phoenix conduct.

To discuss this matter, please contact the writer

Nicholas Crouch
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Liquidator
Trustee in Bankruptcy

Insolvency Practitioners Association

STATEMENT OF INSOLVENCY PRACTICE 16

PRE-PACKAGED SALES IN ADMINISTRATIONS

INTRODUCTION

1. The term 'pre-packaged sale' refers to an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator and the administrator effects the sale immediately on, or shortly after, appointment.
2. The particular nature of an insolvency practitioner's position in these circumstances renders transparency in all dealings of primary importance. Administration is a collective insolvency proceeding - creditors and other interested parties should be confident that the insolvency practitioner has acted professionally and with objectivity; failure to demonstrate this clearly may bring the insolvency practitioner and the profession into disrepute.
3. An insolvency practitioner should recognise the high level interest the public and the business community have in pre-packaged sales in administration. The insolvency practitioner should assume, and plan for, greater interest in and possible scrutiny of such sales where the directors and/or shareholders of the purchasing entity are the same as, or are connected parties of, the insolvent entity.
4. It is equally important that the insolvency practitioner acts and is seen to be acting in the interests of the company's creditors as a whole and is able to demonstrate this.

PRINCIPLES

5. An insolvency practitioner should differentiate clearly the roles that are associated with an administration that involves a pre-packaged sale, that is, the provision of advice to the company before any formal appointment and the functions and responsibilities of the administrator following appointment. The roles are to be explained to the directors and the creditors. For the purposes of this Statement of Insolvency Practice only, the role of "insolvency practitioner" is to be read as relating to the advisory engagement that an insolvency practitioner or their firm and or/any associates may have with a company in the period prior to the company entering administration. The role of "administrator" is to be read as the formal appointment as administrator after the company has entered administration. An insolvency practitioner should recognise that a different insolvency practitioner may be the eventual administrator.
6. The administrator should provide creditors with sufficient information ("the SIP 16 statement") such that a reasonable and informed third party would conclude that the pre-packaged sale was appropriate and that the administrator has acted with due

regard for the creditors' interests. In a connected party transaction the level of detail may need to be greater.

KEY COMPLIANCE STANDARDS

Preparatory work

7. An insolvency practitioner should be clear about the nature and extent of the role of advisor in the pre-appointment period. When instructed to advise the company or companies in a group, the insolvency practitioner should make it clear that the role is not to advise the directors or any parties connected with the purchaser, who should be encouraged to take independent advice. This is particularly important if there is a possibility that the directors may acquire an interest in the business or assets in a pre-packaged sale.
8. An insolvency practitioner should bear in mind the duties and obligations which are owed to creditors in the pre-appointment period. The insolvency practitioner should recognise the potential liability which may attach to any person who is party to a decision that causes a company to incur credit and who knows that there is no good reason to believe it will be repaid. Such liability is not restricted to the directors.
9. The insolvency practitioner should ensure that any connected party considering a pre - packaged purchase is aware of their ability to approach the pre-pack pool (see appendix) and the potential for enhanced stakeholder confidence from the connected party approaching the pre-pack pool and preparing a viability statement for the purchasing entity.
10. An insolvency practitioner should keep a detailed record of the reasoning behind both the decision to undertake a pre-packaged sale and all alternatives considered.
11. The insolvency practitioner should advise the company that any valuations obtained should be carried out by appropriate independent valuers and/or advisors, carrying adequate professional indemnity insurance for the valuation performed.
12. If the administrator relies on a valuation or advice other than by an appropriate independent valuer and/or advisor with adequate professional indemnity insurance this should be disclosed and with the reason for doing so and the reasons that the administrator was satisfied with the valuation, explained.

Marketing

13. Marketing a business is an important element in ensuring that the best available consideration is obtained for it in the interests of the company's creditors as a whole, and will be a key factor in providing reassurance to creditors. The insolvency practitioner should advise the company that any marketing should conform to the marketing essentials as set out in the appendix to this Statement of Insolvency Practice.

14. Where there has been deviation from any of the marketing essentials, the administrator is to explain how a different strategy has delivered the best available outcome.

After appointment

15. When considering the manner of disposal of the business or assets the administrator should be able to demonstrate that the duties of an administrator under the legislation have been met.

Disclosure

16. An administrator should provide creditors with a detailed narrative explanation and justification (the SIP 16 statement) of why a pre-packaged sale was undertaken and all alternatives considered, to demonstrate that the administrator has acted with due regard for their interests. The information disclosure requirements in the appendix should be included in the SIP 16 statement unless there are exceptional circumstances, in which case the administrator should explain why the information has not been provided. In any sale involving a connected party, it is very unlikely that commercial confidentiality alone would outweigh the need for creditors to be provided with this information.
17. The explanation of the pre-packaged sale in the SIP 16 Statement should be provided with the first notification to creditors and in any event within seven calendar days of the transaction. If the administrator has been unable to meet this requirement, the administrator will provide a reasonable explanation for the delay. The SIP 16 statement should be included in the administrator's statement of proposals filed at Companies House.
18. The administrator should recognise that, if creditors have had to wait until, or near, the statutory deadline for the proposals to be issued there may be some confusion on the part of creditors when they do receive them, the sale having been completed some time before. Accordingly, when a pre-packaged sale has been undertaken, the administrator should seek any requisite approval of the proposals as soon as practicable after appointment and, ideally, the proposals should be sent with the notification of the sale. If the administrator has been unable to meet this requirement the proposals should include an explanation for the delay.
19. The Insolvency Act 1986 and the Insolvency (Northern Ireland) Order 1989 permits an administrator not to disclose information in certain limited circumstances. This Statement of Insolvency Practice will not restrict the effect of those statutory provisions.

Effective date: This SIP applies to insolvency appointments starting on or after 1 November 2015

Insolvency Practitioners Association

Appendix

Marketing essentials

Marketing a business is an important element in ensuring that the best available consideration is obtained for it in the interests of creditors, and will be a key factor in providing reassurance to creditors. Any marketing should conform to the following:

- **Broadcast** – the business should be marketed as widely as possible proportionate to the nature and size of the business – the purpose of the marketing is to make the business's availability known to the widest group of potential purchasers in the time available, using whatever media or other sources are likely to achieve this outcome.
- **Justify the marketing strategy** – the statement to creditors should not simply be a list of what marketing has been undertaken. It should explain the reasons underpinning the marketing and media strategy used.
- **Independence** - where the business has been marketed by the company prior to the insolvency practitioner being instructed, this should not be used as a justification in itself to avoid further marketing. The administrator should be satisfied as to the adequacy and independence of the marketing undertaken.
- **Publicise rather than simply publish -** marketing should have been undertaken for an appropriate length of time to satisfy the administrator that the best available outcome for creditors as a whole in all the circumstances has been achieved. Creditors should be informed of the reason for the length of time settled upon.
- **Connectivity -** include online communication alongside other media by default. The internet offers one of the widest populations of any medium. If the business is not marketed via the internet, this should be justified.
- **Comply or explain –** particularly with sales to connected parties where the level of interest is at its highest, the administrator needs to explain how the marketing strategy has achieved the best available outcome for creditors as a whole in all the circumstances.

Information disclosure requirements in the SIP 16 statement

The administrator should include a statement explaining the statutory purpose pursued, confirming that the transaction enables the statutory purpose to be achieved and that the outcome achieved was the best available outcome for creditors as a whole in all the circumstances.

The following information should be included in the administrator's explanation of a pre-packaged sale, as far as the administrator is aware after making appropriate enquiries:

Initial introductions

The source (to be named) of the initial introduction to the insolvency practitioner and the date of the administrator's initial introduction.

Pre-appointment matters

The extent of the administrator's (and that of their firm, and/or any associates) involvement prior to appointment.

The alternative options considered, both prior to and within formal insolvency by the insolvency practitioner and the company, and on appointment the administrator with an explanation of the possible outcomes.

Whether efforts were made to consult with major or representative creditors and the upshot of any consultations. If no consultation took place, the administrator should explain the reasons.

Why it was not appropriate to trade the business and offer it for sale as a going concern during the administration.

Details of requests made to potential funders to fund working capital requirements. If no such requests were made, explain why.

Details of registered charges with dates of creation.

If the business or business assets have been acquired from an insolvency process within the previous 24 months, or longer if the administrator deems that relevant to creditors' understanding, the administrator should disclose both the details of that transaction and whether the administrator, administrator's firm or associates were involved.

Marketing of the business and assets

The marketing activities conducted by the company and/or the administrator and the effect of those activities. Reference should be made to the marketing essentials above. Any divergence from these essentials is to be drawn to creditor's attention, with the reasons for such divergence, together with an explanation as to why the administrator relied upon the marketing conducted.

Valuation of the business and assets

The names and professional qualifications of any valuers and /or advisors and confirmation that they have confirmed their independence and that they carry adequate professional indemnity insurance. In the unlikely event that valuers and /or advisors who do not meet these criteria have been employed, the reasons for doing so should be explained.

The valuations obtained for the business or its underlying assets. Where goodwill has been valued, an explanation and basis for the value given.

A summary of the basis of valuation adopted by the administrator or the valuers and/or advisors.

The rationale for the basis of the valuations obtained and an explanation of the value achieved of the assets compared to those valuations.

If no valuation has been obtained, the reason for not having done so and how the administrator was satisfied as to the value of the assets.

The transaction

The date of the transaction.

Purchaser and related parties

- The identity of the purchaser.
- Any connection between the purchaser and the directors, shareholders or secured creditors of the company or their associates.
- The names of any directors, or former directors (or their associates), of the company who are involved in the management, financing, or ownership of the purchasing entity, or of any other entity into which any of the assets are transferred.
- In transactions impacting on more than one related company (e.g. a group transaction) the administrator should ensure that the disclosure is sufficient to enable a transparent explanation (for instance, allocation of consideration paid).
- Whether any directors had given guarantees for amounts due from the company to a prior financier and whether that financier is financing the new business.

Assets

- Details of the assets involved and the nature of the transaction.

Sale consideration

- The consideration for the transaction, terms of payment and any condition of the contract that could materially affect the consideration.
- The consideration disclosed under broad asset valuation categories and split between fixed and floating charge realisations (where applicable) and the method by which this allocation of consideration was applied.
- Any options, buy-back agreements, deferred consideration or other conditions attached to the transaction.
- Details of any security taken by the administrator in respect of any deferred consideration. Where no such security has been taken, the administrator's reasons for this and the basis for the decision that none was required.
- If the sale is part of a wider transaction, a description of the other aspects of the transaction.

Connected Party transactions only

Where the sale has been undertaken to a connected party the additional details should be included in the SIP 16 statement.

In this context only, a connected party is as defined in section 249 and 435 of the Insolvency Act 1986 and Article 7 and Article 4 of the Insolvency (NI) Order 1989, provided that in determining whether any person or company has control under section 435(10) and Article 4(10), sales to secured lenders who hold security for the granting of the loan (with related voting rights) as part of the secured lender's normal business activities, over one third or more of the shares in the insolvent company, are not included.

Pre-pack pool

The administrator should include one of the following in the SIP 16 statement –

- a statement that the pre-pack pool has been approached by the connected party, or not;
- a statement that the administrator has requested a copy of the opinion given by the pool member.

If an opinion is made by the pre –pack pool and is provided by the connected party to the administrator, a copy of that opinion is to be included within the SIP 16 statement, clearly stating the date of that opinion.

Viability statement

A viability review can be drawn up by a connected party wishing to make a pre-packaged purchase, stating how the purchasing entity will survive for at least 12 months from the date of the proposed purchase. The connected party should consider providing a short narrative detailing what the purchasing entity will do differently in order that the business will not fail ("the viability statement).

The administrator should request that the connected party considering a pre-packaged purchase provide a copy of their viability statement.

- If provided, it should be attached to the SIP 16 statement.
- If the viability statement has been requested but not provided, the administrator should notify creditors of this in the SIP 16 statement.

Reforms to Address Corporate Misuse of the Fair Entitlements Guarantee Scheme

Submission

Richard Fisher AM

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Adjunct Professor, Faculty of Law, The University of Sydney

Honorary Member, ARITA

Formerly, Partner, Blake Dawson Waldron (now Ashurst) (1984 – 2007)

Formerly, Commissioner, Australian Law Reform Commission (1986 – 1989)

Executive Summary

For the reasons advanced in this Submission, it is argued that, in certain circumstances, a pre-pack or a pre-positioned sale of a company's business can assist mitigate the misuse of the Fair Entitlements Guarantee Scheme whilst, at the same time, can be undertaken in an environment which avoids the sharp corporate practices which have been identified as facilitating that misuse. In essence, that environment is as follows:

(a) pre-packs should only be permitted when the value of the company's business is less than a prescribed amount, probably no more than $250,000;

(b) pre-packs can only be negotiated under the supervision of an independent insolvency practitioner;

(c) the independent insolvency practitioner should be permitted to act as liquidator or administrator of the company in the event of a voluntary administrator being appointed or it being wound up;

(d) the independent insolvency practitioner should be required to provide creditors with a certificate containing the information detailed in paragraph 9 of the Statement of Insolvency Practice 16 issued by the UK Institute of Chartered Accountants which is **attached** as **Annexure 2**; and

(e) in addition, the independent insolvency practitioner should certify that the sale price was at least equal to the amount determined by an independent valuer of the assets which are the subject of the sale.

1. **Background**

1.1 The consultation paper dated May 2017 in relation to the Corporate Misuse of the Fair Entitlements Guarantee ("***FEG***") Scheme ("***Consultation Paper***") identifies the following issue of central concern:

> *"Costs of the FEG Scheme have been increasing due to the adoption of sharp corporate practices by select employers and parties associated with them, resulting in cost shifting to the Scheme and through it, to taxpayers."*

1.2 Those sharp practices include, relevantly for the purposes of this submission, the following:

(a) utilising fraudulent or unlawful phoenix company activities and arrangements;

(b) the adoption of deliberate practices by certain company directors, company officers, and some advisors in seeking to unfairly manage an insolvency to the detriment of creditors.

1.3 The Consultation Paper identifies a number of law reform initiatives intended to discourage and penalise those activities. It is not necessary for the purposes of this submission to identify those initiatives in detail. It is sufficient to say that they are supported.

2. Additional Law Reform Initiatives

2.1 It is submitted that, in addition to the adoption of law reform initiatives which discourage the "*sharp corporate practices*" identified in the Consultation Paper, it is also appropriate to explore other law reform initiatives which will mitigate the effect of corporate failures on the FEG Scheme.

2.2 Such law reform initiatives may be as much concerned with creating a legislative environment which facilitates the preservation of either companies or their businesses and secures the ongoing engagement of the company's employees as discouraging and penalising those "*sharp corporate practices*".

2.3 It is submitted that one such law reform initiative was identified by the Productivity Commission in its report on the Inquiry into Barriers to Business Entries and Exits ("***Productivity Commission Report***"). Reference is made in this regard to Recommendation 14.3 of the Commission's Report:

> "***Recommendation 14.3:***
>
> *Provision should be made in the Corporations Act 2001 (Cth) ("**Act**") for 'pre-positioned' sales.*
>
> *Where no related parties are involved, there should be a presumption of sale such that administrators can overturn sales only if they can prove that the sale was not for reasonable market value (in accordance with s420A of the Act), or if it would unduly impinge on the performance of the administrators' duties. Administrators or liquidators should be able to rely on the pre-appointment sale process as evidence.*
>
> *If sales are to related parties, there is no presumption favouring sale and the administrator's or liquidator's examination of the sale process continues as normal. The administrator's review should include checks that the sale has met existing regulatory requirements for related party transactions.*
>
> *In both cases, s439A of the Act should be amended to include requirements to disclose information of the sale to creditors.*
>
> *Where the sale (whether given effect before or after the insolvency appointment) is the result of advice received under the safe harbour defence, that defence should also apply against voidable transactions actions from administrators or liquidators.*"

2.4 For the purposes of this submission, "*pre-positioned*" sales (which are also known as "*pre-packs*" and will be described in this submission in that way) are defined:

"A process of arranging the sale of a company's business before the formal appointment of a liquidator, who will finalise the sale as soon as possible after their appointment."

2.5 The Australian Government did not support Recommendation 14.3 of the Productivity Commission for these reasons:

> *"Currently, a liquidator or administrator will assess any contract for sale entered into prior to the administration but not yet completed, to determine whether it is in the interests of creditors to honour it. A liquidator may elect to honour a contract for sale, or to allow the counterparty to lodge a claim in the administration. Any presumption in favour of a sale would fetter the liquidator's ability to carry out this function.*
>
> *The Government does not believe that this would be a desirable policy outcome.*
>
> *The Government notes also that the UK's non-legislative 'pre-pack' administration has attracted considerable criticism because of perceptions that it may facilitate fraudulent phoenix activity."*

2.6 It is accepted that fraudulent or unlawful phoenix activity is both to be discouraged and that its practice brings the process of liquidating companies into disrepute. It is for that reason that the recommended law reform initiatives in the Consultation Paper are supported.

2.7 Further criticisms of pre-packs were identified by Teresa Graham CBE who undertook a review into pre-pack administrations for the British Government, the final report of which is dated June 2014 ("***Graham Review***"). The Report of the Graham Review concluded (at page 20), relevantly, that pre-packs suffered from the following "*negatives*":

"• *Pre-packs lack transparency*

• *Marketing of pre-pack companies for sale is insufficient*

• *More could be done to explain the valuation methodology*

• *Insufficient attention is given to the potential viability of the new company*

• *The regulation - and monitoring of that regulation - of pre-pack administration could be strengthened."*

2.8 Against those criticisms, though, the Graham Review concluded that pre-packs delivered the following "*positives*":

"• *Pre-packs can preserve jobs*

• *Pre-packs are cheaper than an upstream procedure*

• *Deferred consideration is, by and large, paid (and in particular where it is due within 6 months) - old company creditors are not unduly harmed by the presence of deferred consideration in a pre-pack deal*

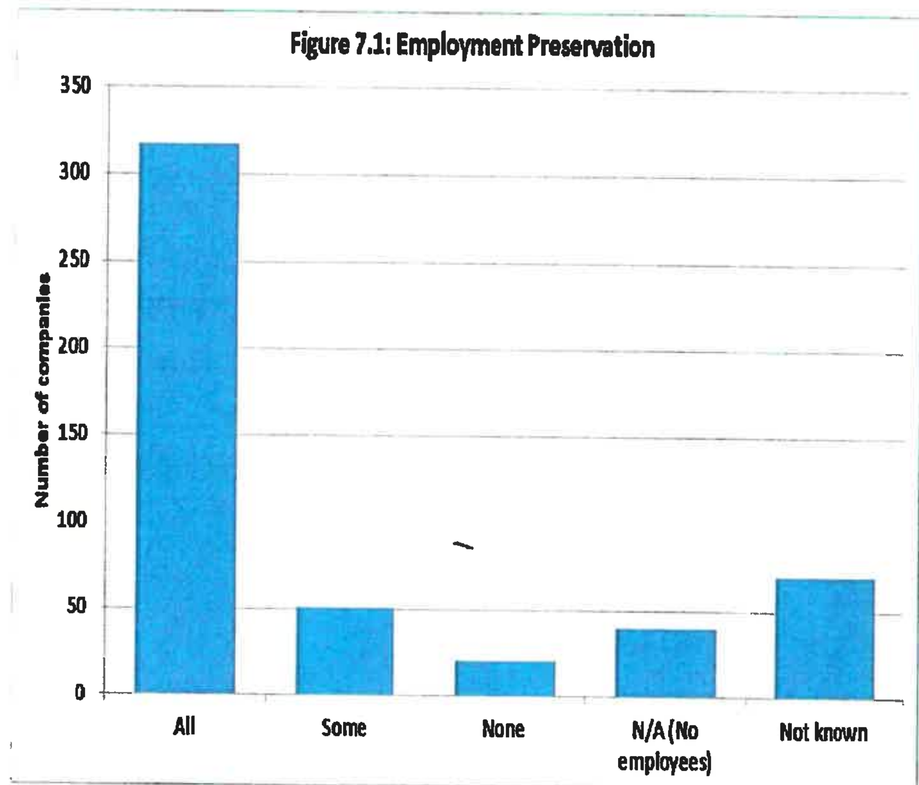
• *Where comparing like with like, pre-packed new companies are, on average, more likely to succeed than business sales out of trading administrations*

- *Pre-packs may bring some limited benefit to the overall UK economy from overseas companies relocating their pre-pack activity to the UK."*

2.9 It is to be noted that, in particular given the context of this submission, the Graham Review concluded that pre-packs can save jobs. As to that matter, the work of the Graham Review was supported by research undertaken by the University of Wolverhampton.

2,10 That research involved a sample of nearly 500 companies which entered into pre-pack administrations in 2010. In relation to the finding that pre-packs can preserve jobs, the Report of the Graham Review says (at 24-25):

> "***Pre-packs preserve jobs***
>
> *7.9 Employment preservation, however, is an area where I have been able to test the assertion that pre-packs are good for jobs. I was keen that the academic research should look at prospects for the old company employees of the sample companies.*
>
> *7.10 A large number of SIP16 statements cited the preservation of employment as one of the reasons to pre-pack. The benefit is often reported by administrators as the preservation of the jobs themselves, but more usually as achieving a reduction in the likely preferential and unsecured creditor claims were the employees to be made redundant as a result of old company's insolvency. This may have been because the legislation does not cite 'saving jobs' as a statutory objective but does stress that the administrator must act in creditors' interests. Saving jobs is important for other creditors, including floating charge holders, as part of what the old company would otherwise have owed to its employees would be classed as preferential and so paid in priority to floating charge creditors and unsecured non-preferential creditors.*
>
> *7.11 Despite this, the information regarding employment preservation reported in the SIP16 statements was often poor. It would appear that where all of the jobs had been saved, this was reported to creditors . However, where less than 100% employment preservation had been achieved, the information given in these statements became more opaque.*
>
> *7.12 The veracity of these figures cannot be confirmed and neither can the length of the 'new' employment. It is not possible on the data presented to provide comment on the extent of employment preservation in the 51 cases categorised as 'some'. Nonetheless it appears that, the claim by proponents of pre-packs that they preserve jobs is a correct one.*



2.11 If similar results could be achieved in Australia, then it is submitted that the principal policy objective identified in the Consultation Paper could be significantly advanced.

2.12 More recent analysis of the UK experience with pre-packs may be found in the 2016 Annual Review of the Pre Pack Pool which is **attached** as **Annexure 1**.

2.13 Beyond experience in the UK, it is to be noted that;

(a) pre-packs are possible under Chapter 11 of the US *Bankruptcy Code*;

(b) amendments were made to the New Zealand *Companies Act*, 1993 (ss386A, 386C, and 386,D) which facilitate pre-packs; and

(c) whilst the outcomes of its deliberations are not yet known, UNCITRAL has established Working Group V (Insolvency) to consider regimes appropriate for micro and small to medium enterprises.

3 Benefits from Pre-packs

3.1 To put the prospective benefits to be derived from pre-packs into context, an important consideration is in the analysis of the results of the current insolvency regimes.

3.2 Taking the most recently available data from ASIC, in 2015 – 2016:

(a) 9,465 companies entered external administration;

(b) of that number, 8,168 had assets of less than $100,000;

(c) of that number, 2,381 had assets of between $20,000 and $100,000;

(d) of that number, a further 519 had assets of between $100,000 and $250,000; and

(e) of that number:

 (i) 6,202 had less than 5 FTE staff; and

 (ii) a further 1,253 had between 5 and 19 FTE staff.

3.3 A study conducted by Mark Wellard; "*A Sample Review of Deeds of Company Arrangement Under Part 5.3A of the Corporations Act*" which was published in 2014 reviewed a number of voluntary administrations conducted in 2012 and 2013. That study concluded:

> "*The typical cost (in insolvency practitioner fees) of a voluntary administration which precedes a "small company" DOCA [Deed of Company Arrangement] is around $31,500, while a typical amount of remuneration charged by a Deed Administrator for the administration of a DOCA is $28,700.*" [A small company DOCA is described as a Deed under which assets of a value of less than $1.5 million are administered]

3.4 In these circumstances, it is reasonable to conclude that, if a voluntary administration followed by a DOCA is the approach adopted for restructuring a company and either preserving the company or its business, a very substantial proportion of the proceeds of realisation of its assets will be applied to satisfy both the remuneration of the administrator as well as the costs and expenses associated with the administration. Accordingly, it is submitted that, if a company or its business is to be restructured and its employees provided with continuing employment rather than being made redundant and the associated costs being imposed on the FEG Scheme, a less expensive process than that involved with voluntary administration is required.

3.5 Such a process was identified by the Productivity Commission in Recommendation 15.1 and Recommendation 14.4 in its Report which read:

> ***"Recommendation 15.1**:*
>
> *The Corporations Act 2001 (Cth) should be amended to provide for a simplified 'small liquidation' process.*
>
> - *this would only be available for those companies with liabilities to unrelated parties of less than $250,000.*
> - *to access small liquidations, directors should be required to lodge a petition to the Australian Securities and Investments Commission (ASIC) and verify that their books and records are accurate.*
> - *the primary role of the liquidator would be to ascertain the funds available to a reasonable extent, given a reduced timeframe. Requirements for meetings, reporting and investigations should be*

reduced accordingly.

- *the pursuit of unfair preference claims should be limited to those within three months of insolvency and material amounts. The duty to pursue unfair preference should be explicitly removed unless there is a clear net benefit and it will not impede conclusion of the liquidation.*

- *creditors would be able to opt out of the process and into a standard creditors' voluntary liquidation, and ASIC would be able to initiate further investigation if it has concerns of illegality.*

Liquidators for these processes would be drawn from a panel of providers selected by tender to ASIC. Panel membership would be for a period of up to five years, with ASIC able to conduct tenders at regular intervals to ensure that demand can be met.

ASIC should be empowered to hear complaints of practitioner misconduct and if the complaint is upheld, replace the liquidator. ASIC should be enabled to take disciplinary action, if warranted, against the discharged liquidator, including the suspension from participation in the panel or revocation of their registration."

Recommendation 14.4

"*The small liquidation process detailed in recommendation 15.1 should include provision for small pre-positioned sales, consistent with recommendation 14.3.*

In the context of small businesses, the requirements of s420A of the Corporations Act 2001 *(Cth), and investigations of related parties, should be applied proportionately in relation to determining the relevant market for the sale, advertising effort and reasonable price."*

4 Pre-packs; Should they be a Policy Concern?

4.1 It is submitted that, in the context of the principal issue being addressed by the Consultation Paper, it is appropriate to test whether balance can be struck between the benefits which can be reasonably calculated to be available from permitting pre-packs; particularly saving jobs, with the "*costs*" associated with the possibility of facilitating fraudulent phoenix activity and the other negatives identified by the Graham Review.

4.2 Those costs need to be calculated having regard to:

(a) the law reform initiatives proposed in the Consultation Paper which are advanced as mitigants to such activities; and

(b) the legislative environment which could be adopted to support pre-packs.

4.3 It is submitted that, in addition to the adoption of the Productivity Commission's Recommendation 14.3, consideration should also be given, subject to one exception, to the adoption of its Recommendation 15.1. If that Recommendation were adopted and it was only pre-packs which:

(a) involved a sale whether to a party related to the company's directors or a third party;

(b) concern the assets of a company whose total assets are valued at a prescribed amount being, say, no more than $250,000; and

(c) are at a price at least equal to an independent valuation of the assets being sold which was obtained by that insolvency practitioner

to which Recommendation 14.3 of the Productivity Commission (in its legislative form) applied, that would also militate against fraudulent or unlawful phoenix activity or, at the very least, mitigate its adverse effect given the limitation on the value of the assets (however ascertained) involved and the process of determining the minimum sale price.

The recommendation of the Productivity Commission that pre-packs be undertaken under the supervision of an insolvency practitioner drawn from the panel of providers selected by tender to ASIC has not been adopted. The Productivity Commission Report was published in 2015 prior to the adoption of the *Insolvency Practice Rules (Corporations)* 2016. For the time being at least the efficacy of those Rules should be able to be tested before consideration is given to the introduction of further regulation of the profession.

4.4 Where a pre-pack is undertaken in that way and for so long as the insolvency practitioner's involvement is limited to:

(a) advising as to the options available to the company, given its financial circumstances;

(b) the supervision of the sale process; and

(c) obtaining the independent valuation

that person should be able to act as liquidator or voluntary administrator for the company as the case requires.

4.5 The protection against fraudulent or unlawful phoenix activity should be further fortified under the supervisory regime for which provision is made in the *Insolvency Practice Rules (Corporations)* 2016.

4.6 It is submitted that these initiatives taken collectively are calculated and can be reasonably expected to militate against fraudulent or unlawful phoenix activity. It is further submitted that those initiatives can mitigate the policy "*costs*" of which it is apprehended might have to be borne if pre-packs facilitate that activity. The reasons are that:

(a) there is the requirement for the involvement of an independent insolvency practitioner;

(b) their activities can be effectively scrutinised under the *Insolvency Practice Rules (Corporations)* 2016;

(c) pre-packs would only be permitted when the value of the company's business is less than a prescribed amount, probably no more than $250,000 and when it has been negotiated under the supervision of an independent insolvency practitioner;

(d) the sale of that business would be required to be undertaken at a price which is at least equal to the value of the assets being sold as determined by an

independent valuer and certified as such by the independent insolvency practitioner; and

(f) the independent insolvency practitioner should be required to provide creditors with a certificate containing the information detailed in paragraph 9 of the Statement of Insolvency Practice 16 issued by the UK Institute of Chartered Accountants which is **attached** as **Annexure 2**.

In this environment it is also submitted that there can be no sensible objection, in the ordinary course, to the independent insolvency practitioner acting as, say, voluntary administrator of the company and either its liquidator or as the administrator of any deed of company arrangement which it undertakes.

4.8 It is accepted that the use of a valuation to test price may be less rigorous an approach to establishing "*true*" value than a marketing process. However, when undertaking the appropriate cost benefit analysis, if pre-packs are only available in the case of sales when the assets being sold are valued at less than, say, $250,000, the deficiency, in terms of the adverse impact on creditors, would be minimal. Moreover, for reasons explored below, it is possible that creditors may receive a better return than would be the case if, say, there was a voluntary administration followed by the execution of a Deed of Company Arrangement. Without there being at the same time a pre-pack.

5 Conclusion

5.1 For the reasons explored above, it is submitted that it would be possible to further alleviate the burden on the FEG Scheme of the redundancy of employees consequent upon the liquidation of their employer by permitting pre-packs to be undertaken:

(a) under the supervision of an independent insolvency practitioner;

(b) in the context of "small to medium sized companies";

(c) at a price which is no less than the independently determined value of the assets being sold; and

(d) otherwise, subject to the "checks and balances" described in this submission.