18 March 2016

TURNAROUND MANAGEMENT ASSOCIATION (TMA) SUBMISSION TO SENATE ECONOMICS REFERENCES COMMITTEE

CAUSES AND CONSEQUENCES OF THE COLLAPSE OF LISTED RETAILERS IN AUSTRALIA

Overview

The Turnaround Management Association[1] welcomes the Senate's invitation to comment on the above topic. Although in essence we submit that there is no need for such an enquiry as existing law already protects creditors, including gift-card holders, sufficiently. The focus of government should be on facilitating turnaround.

Senators are well acquainted with the notion of capital seeking out reward, for risk.[2] Business failures are an ordinary part of commercial life, as are calls for different forms of regulation following high profile failures.

Australian listed businesses, retailers and others, operate in one of the world's most stringent legal regimes. The obligation to conserve capital in distressed situations is a form of statutory insurance policy in favour of creditors. Personal liability for insolvent trading provides a significant check on director conduct.

Liquidators, class action plaintiffs, regulators and unhappy creditors already enjoy the means to hold to account nonperforming directors, auditors, sellers, brokers and others who have provided disclosure statements or verified financial records.

Legislative reform should focus on providing safe harbour defences for directors and means to save companies through turnaround. A saved company is good for jobs, preserves revenue streams, does not dislocate business and supplier communities and saves on unnecessary agency costs.

This has been recognised by the government in its recent Innovation Statement, which proposed a number of safe harbour reforms to promote calculated risk taking by directors of distressed companies to facilitate the recovery of distressed businesses.

Recommendations

The best way to protect those holding gift cards, and indeed all other affected creditors of a distressed company, including employees, is to maximise the chances of the business surviving. This is done by early engagement with advisors, innovation and calculated risk taking by directors. The TMA welcomes the safe harbour reforms, and considers that the government's time spent in the insolvency and restructuring space should be devoted to that rather than inquiry into individual corporate collapses.

It is still necessary to have sanctions for wrongdoing but we consider that this is adequately covered by the *Corporations Act* and existing law.

Directors and officers of companies owe the company, and in some circumstances its creditors, a number of duties. There are significant penalties and remedies available for breach of those duties. No additional regulation or oversight is needed. Absent irregularity, it is folly to change a system to focus on a particular circumstance.

The quite legitimate commercial decision making of a director, administrator or receiver does not justify inquiry by the government.

[1] Information concerning the TMA is set out in appendix 1.

[2] Senators are respectively referred to the paper delivered by the Productivity Commission titled "Business Failure and Change: An Australian Perspective" by Ian Bickerdyke, Ralph Lattimore and Alan Madge.

PO Box H354, Australia Square, NSW 1215 **P** 1300 042 811 **E** info@turnaround.org.au
W www.turnaround.org.au ABN 96 107 241 798 Turnaround Management Association Australia Limited

This is particularly so with respect to an insolvency practitioner's decision making in relation to gift cards. In corporate collapses such as the receivership of Clive Peeters Ltd, the insolvency practitioner will honour gift cards subject to certain conditions, such as a requirement that the customer spend a set further amount in cash. It is of course open to the insolvency practitioner not to honour gift cards at all, as occurred in the recent Dick Smith collapse. The practice varies from case to case depending on the circumstances and the overall strategy of the insolvency practitioner to deliver the best return for creditors as a whole.

Finally, Australia has a sophisticated insolvency regime and procedures. We have extensive processes enshrined in law to investigate corporate collapses, impose penalties on those responsible and provide creditors with the maximum return possible. We also have an evolved payment waterfall to deal with the order in which creditors are paid in a just and equitable manner.

In our submission, that liquidation payment priority waterfall should not be altered to give gift card holders an elevated position ahead of other creditors.

Appendix 2 provides specific answers to the questions posed.

APPENDIX 1

BACKGROUND TO THE TMA

The Turnaround Management Association ("TMA") is an organisation founded in the United States in 1987 and has more than 8,200 members globally. It continues to be very strong in the United States; but, it is now the primary global body representing members which form a professional community that seeks to strengthen the global economy by working to save distressed businesses, assisting management to navigate off-plan events, and helping healthy companies avoid similar pitfalls. TMA's mission is to serve as a forum for corporate renewal professionals from all disciplines to promote high standards of practice, foster professional development, and enhance the image of TMA members. All TMA members are expected to abide by a Code of Ethics, specifying high standards of professionalism, integrity, and competence.

The TMA in Australia was started in 2003 and has a diverse membership which comprises 561 seasoned advisory professionals including those who lead turnaround situations, such as specialist turnaround management, lawyers, investment bankers such as myself, insolvency professionals and accountants. Its members also include the capital providers which are vital to corporate recovery such as hedge funds which provide the risk capital to recapitalise companies and the commercial banks that provide traditional debt financing.

TMA Australia's current Board of Directors include:

Tim Stewart	Royal Bank of Scotland	*Chairman*
Lachlan Edwards	Lazard	*President*
Cameron Belyea	Clayton Utz	*Vice President*
Chris Martin	333	
Michael Sloan	Ashurst Australia	
Jennifer Ball	Clayton Utz	
Premjit Kaur	Fortress Investment Group PL	
John Nestel	Herbert Smith Freehills	
Carl Gunther	KPMG	
Stuart King	National Australia Bank	
Tim Williams	National Australia Bank	
Phil Carter	PPB Advisory	
Anthony Boswell	PricewaterhouseCoopers	
Marcus Derwin	R Cubed Group	
Darren Stacey	Suncorp Bank	
Andrew Birch	Vantage Performance	

TMA Australia Chapter

APPENDIX 2

ANSWERS TO SPECIFIC QUESTIONS POSED BY THE INQUIRY

1. FRAME OF REFERENCE

You have invited the TMA to make submissions on the causes and consequences of the collapse of listed retailers in Australia, with particular reference to:

(a) the conduct of private equity firms prior to, during and after corporate takeovers;

(b) the role of the Australian Securities and Investments Commission and the Australian Competition and Consumer Commission in overseeing corporate takeovers;

(c) the effect of the appointment of external administrators on secured and unsecured creditors, including employees and consumers of retail businesses;

(d) the effect of external administration on gift card holders and those who have made deposits on goods not delivered;

(e) the desirability of the following proposals in the event that gift card holders are unable to redeem their gift cards following the appointment of external administrators:

(i) placing an obligation on external administrators to honour gift cards,

(ii) a requirement that funds used to purchase gift cards be kept in a separate trust account by businesses,

(iii) directors to be personally liable for the value of gift cards purchased; and

(f) any related matters.

2. CONDUCT OF PRIVATE EQUITY FIRMS PRIOR TO, DURING AND AFTER CORPORATE TAKEOVERS

We do not propose to deal with the role of private equity in flipping a private buy into a listed vehicle, but instead our submissions focus on the sufficiency of existing regulatory protections and accounting treatments as the natural checks and balances in any IPO or takeover.

3. OVERSEEING CORPORATE TAKEOVERS

3.1 Takeovers

Takeovers in Australia are regulated by Part 5.1 and Chapter 6 of the *Corporations Act*, governmental policy developed by ASIC and the Takeovers Panel, the listing rules of the ASX and the anti-trust rules administered by the ACCC.

The takeovers rules and policies are based on the principles set out in Chapter 6 of the *Corporations Act,* being:

(a) that the acquisition of control of a relevant entity (being one of the types of entities described above) takes place in an efficient, competitive and informed market;

(b) that the security holders and directors of a relevant entity:

(i) know the identity of any person who proposes to acquire a substantial interest in entity;

(ii) have a reasonable time to consider the proposal; and

(iii) are given enough information to assess the merits of the proposal;

(c) that as far as practicable, the entity's security holders should all have a reasonable and equal opportunity to participate in any benefits accruing to the entity's security holders through the proposal; and

(d) that an appropriate procedure is followed as a preliminary to compulsory acquisition of the entity's securities under the *Corporations Act*.

Significant disclosure to shareholders and the market is required before a takeover can occur. A number of documents, which are subject to extensive verification and due diligence, must be issued to ensure that the market and stakeholders are fully informed of the offer terms, funding sources, intentions for the target and all other information known to the bidder and by the target shareholders which is material to target shareholders. These documents are subject to ASIC review.

There are significant civil and criminal penalties for misleading or deceptive statements or omissions from takeover, compulsory acquisition or buy out documentation.[3] A person who suffers loss and damage that results from such a contravention is able to seek compensation for that loss or damage from a director or any person who is named in the document with their consent as having given the statement.[4]

3.2 IPOs

The prospectus must, under the *Corporations Act*, contain all information that investors (and their advisors) would reasonably require and expect to be contained in the prospectus in order to make an informed assessment of material matters of the company, including the company's assets and liabilities, financial position, profits, losses and prosects. Further, the prospectus must not contain a false, misleading or deceptive statement or omit material information.

ASIC and the ASX do not review prospectuses prior to lodgement and launch of the IPO. The onus is on the directors of the company to ensure that it complies with the requirements of the *Corporations Act*. However, ASIC does review prospectuses after they are registered. This review takes place over seven days and the company cannot accept applications for shares while this review takes place. Following completion of the IPO process, once trading of the company's shares commences, the new listed company will need to comply with the detailed continuing obligations in the ASX Listing Rules, including continuous disclosure, financial reporting and corporate governance obligations.

3.3 Mechanisms for seeking compensation for misinformation

Listed retailers operate in a highly regulated market which requires continuous disclosure and governance, financial reporting and audit requirements. IPOs and takeovers are well regulated exercises, both at the *Corporations Act* regulatory and at the ASIC guidance level. Further, they are a well interrogated exercise, as investors, financial planners, analysts and financial market commentators review and model the information contained in the disclosure documents required for these types of transactions.

Where the board or management have failed in their duties to keep the market informed, ASIC or class action warriors are able to take appropriate action.

Significant settlement sums have been reached in respect of shareholder class action claims in recent years, and with the increase in availability of litigation funding vehicles the class action has become a very real mechanism for seeking compensation for prospectus liability or other misinformation claims against a company or its directors and advisors.

ASIC has powers to impose a civil penalty order of up to $200,000 where a director is found to have breached his or her duties, and that breach materially prejudiced the interests of the company, its

[3] *Corporations Act s 670A.*

[4] *Corporations Act s 670B.*

TMA Australia Chapter

members or its ability to pay its creditors or is otherwise "serious". ASIC may also seek an order that the director be disqualified from being a company director for a set period.

Directors who breach their duties may also be criminally liable for their actions in circumstances where their conduct involves recklessness or intentional dishonesty.

The relevant question is not whether the business has been mismanaged but whether the directors and officers have discharged relevant fiduciary and fair dealing obligations.

In relation to Dick Smith, the relevant question needs to focus on the regularity of accounting treatments on stock and inventory and the valuation methods used in the IPO. Absent irregularity, it is folly to change a system to focus on a particular circumstance.

4. THE EFFECT OF THE APPOINTMENT OF EXTERNAL ADMINISTRATORS ON SECURED AND UNSECURED CREDITORS, INCLUDING EMPLOYEES AND CONSUMERS

4.1 Distributions to unsecured creditors

The proceeds of claims made against the company by an insolvency practitioner ultimately flow through to the creditors of the company as part of a distribution to creditors.

The general rule in liquidations is that all company funds should be distributed "pari passu" to the creditors – this means equally and rateably. However, certain debts of the company must be paid out of the assets of the company as a priority, before the "pari passu" principle applies – these include properly incurred expenses of the liquidator, certain employee entitlements and tax obligations.

In practice, this means that if there are sufficient assets to do so, the liquidator will declare and distribute a dividend to creditors after all priority debts have been paid. The dividend represents a set percentage of cents in the dollar owing to each ordinary unsecured creditor.

5. PROPOSALS WITH RESPECT TO REDEMPTION OF GIFT CARDS FOLLOWING THE APPOINTMENT OF EXTERNAL ADMINISTRATORS

Gift card holders are ordinary unsecured creditors. In a liquidation, unsecured creditors share in the proceeds of the liquidation on a pari passu basis, after priority creditors, like employees, are paid their entitlements. In our view, there is no reason why gift card holders should, by legislative intervention, be placed ahead of other unsecured creditors in receiving a distribution from the assets of the company.

We have set out below our reasons as to why the proposals with respect to redemption of gift cards are not appropriate.

5.1 Placing an obligation on external administrators to honour gift cards

It is not appropriate to place an obligation on external administrators to honour gift cards. In cases of receivership or administration where it is likely that the company will be restructured or trade on in some capacity, it may be a useful strategy in the administration for the administrator to honour gift cards, in order to foster continued goodwill and to continue to bring customers in to the store. However, this is a matter for the relevant insolvency practitioner to consider – in light of their duties and obligations to all creditors and the actions that are likely to deliver the highest return to creditors.

The imposition on liquidators of an obligation to honour gift cards in a liquidation would effectively place gift card holders ahead of other unsecured creditors. There is no good reason why gift card holders should be placed ahead of other unsecured creditors.

5.2 Imposing a requirement that funds used to purchase gift cards be kept in a separate trust account by businesses

The rules relating to distribution of property held on trust by a company in liquidation are complex. Generally, assets held on trust are excluded from the estate of an insolvent company. The creditors of a trustee have no direct recourse to assets held on trust, but only a personal right against the trustee (the insolvent company).

However, this general rule has been construed by courts as providing beneficiaries with an unfair windfall, since it means in practice that assets held on trust are not available to meet debts incurred by a trustee on behalf of the trust. Courts have therefore varied the general position. Although the assets held on trust do not form part of the estate of the insolvent company, where the trustee has a right to be indemnified from those assets, ordinary creditors will have priority over beneficiaries of the trust account.[5]

The determination of priority with respect to the proceeds of a gift card trust fund would not be a straightforward exercise. Further, the administration of a separate trust account may result in onerous procedures for the company in selling gift cards.

5.3 Directors to be personally liable for the value of gift cards purchased

Directors have a number of duties at law and under the *Corporations Act*. In particular they have duties to act in good faith, in the best interests of the company with due care, skill and diligence and not to use their position for an improper purpose. Further, they have duties to prevent insolvent trading. Directors are personally liable for debts incurred by the company at a time when it is insolvent, losses caused by breaches of directors' duties, illegal phoenix activity and for any guarantees or other security given by directors over personal assets.

Where the issue or sale of gift cards occurs in breach of a director's duty or at a time when the company is insolvent, a customer, or multiple customers through the mechanism of a class action, may claim compensation from the director under existing legislation. However, absent a breach of duty, it is not clear why directors should bear the burden of personal liability to customers for the value of gift cards purchased.

Such reform would be the antithesis of Safe Harbour reform.

5.4 Insurance scheme to honour gift cards

If it is accepted as a premise that the legislature should not alter creditor priorities in failed companies, the real question, from a political level, would then be whether some additional legislative protection should be afforded to consumers. A self-insurance or government insurance scheme, such as the Fair Entitlements Guarantee scheme for employees who lose their job due to the bankruptcy or insolvency of their employer, could be implemented for the holders of gift cards.

In our submission, the cost of administering such a scheme would be prohibitive in circumstances where the claims made by individual gift card holders are likely to be numerous but small in value.

There is no sound reason to promote the economic interests of gift card holders over other unsecured creditors.

---

[5] *Vacuum Oil Company Pty Limited v Wiltshire* (1945) 72 CLR 319 and *Octavo Investments Pty Limited v Knight* (1979) 144 CLR 360.

PO Box H354, Australia Square, NSW 1215 **P** 1300 042 811 **E** info@turnaround.org.au
W www.turnaround.org.au ABN 96 107 241 798 Turnaround Management Association Australia Limited