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Senate Inquiry into Corporate Insolvency

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Dear Sir/Madam

I wish to make a second submission to the Senate Inquiry into corporate insolvency in Australia.

I am a liquidator and trustee in bankruptcy with almost 20 years experience in the field.

Executive Summary

My suggestions for corporate insolvency reform are detailed below.

1. Australia should embrace pre-packs. My preferred pre-pack model is a system where the voluntary administrator holds the purchase price in trust for 14 days and reviews the sale by management to determine if the market value for a related party sale was realised.

   If the sale is at less than market value, the voluntary administrator should set aside the sale without court intervention, refund the sale proceeds and act as voluntary administrator with a view to trade on and sell the business.

   Pre-pack sales to non related parties should continue to be scrutinised via 588FB of the Act (uncommercial transactions), however there is merit in reversing the onus of proof in relation to establishing market value.

   The three most important issues in any pre-pack should be:

   a. Ensuring the market value is realised for the assets that are sold. The minimum standard should exceed the amount that would be available in a virtual liquidation.

   b. Management must deal with the insolvent company's assets as if they belong to the creditors.

   c. Insolvent trading should not occur during a pre-pack sale process.

2. Directors should be automatically issued a director penalty notice and thereby be potentially personally liable for taxation obligations after a 6 month moratorium to pay overdue taxation obligations. The ATO made a similar proposal in 2009.[15]

3. The onus of proof for insolvent trading should also be reversed if an ATO debt is outstanding for a similar 6 month period.

4. Insolvency appointments should be rotated to a new liquidator and large jobs split up and several liquidators appointed after twelve months to eliminate the rorting of large jobs by insolvency practitioners.

5. The onus of proof for voidable transactions that involve related parties should be reversed.

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Introduction

The Corporations Act is now seriously out of step with comparable countries legislation due to its failure to encourage the sale of an insolvent company's business prior to its liquidation.

In the US and UK, a "pre-pack" refers to the process of selling an insolvent company's business or assets before the company goes into liquidation or administration.

The sale is coordinated by the insolvent company's existing management. Typically, the assets or business are sold for market value to a related company which I will call New Co. New Co re-employs the existing staff and produces the same goods and services from the same premises.

I know you're thinking "that's a phoenix. That's illegal." I'm here to challenge that view.

I will start in the USA. General Motors, the largest US auto manufacturer was sold as a pre-pack for $50 billion in late 2009. The sale was finalised only 40 days after initiating the protection of Chapter 11 of the US Bankruptcy Code. 225,000 staff were re-employed by New GM Inc after it purchased the $85 billion of assets from old GM. The purchase was funded and approved by the US Government. GM was the 4th largest corporate failure in history and is the biggest pre-pack to date.[1]

The largest corporate failure to date is Lehman Brothers. The day after Lehman Brothers entered Chapter 11 protection, Barclays Bank announced its agreement to purchase its investment-banking assets. A week later that agreement was approved by the Courts. This sale wasn't a pre-pack but it was a sale of $600 billion in assets made within 24hours with the regulator's rubber stamp.[2] It demonstrates a quick sale can be a good sale.

The United States has used the pre-pack model of selling assets since 1978. Last year about 12,000 companies used the framework in an attempt to restructure and save their business.

The entire structure of Chapter 11 is designed to provide existing management with time to sell an insolvent business into a new entity. The US system is cumbersome and expensive because it's Court-sanctioned.

I will now jump to the United Kingdom.

The UK Insolvency Act 1986 was revamped by the Enterprise Act 2002 which permitted a company to appoint an administrator without judicial scrutiny. The UK Act was modelled on Australia's VA Law. But it has same twists.[3]

The most significant difference between the Australian voluntary administration procedure and the UK version is the UK administrator gets in early and assists management undertake the pre-pack sale of assets prior to their formal appointment. Once the terms of the sale have been agreed, including the consideration, the UK administrator is appointed who immediately signs the contract for sale.[4]

Let me reiterate this point, the amazing thing about the UK pre-pack process is the administrator will typically sign off on the pre-pack sale on the day of their appointment.

In the UK there are around a 100 pre-pack sales a month.[5]

Some examples of UK pre-pack sales during the past 12 months include:

- Officers Club, the men's retail clothing chain sold to the existing management by PWC immediately after their appointment as administrator. This business had 120 retail stores and more than 1000 staff.

- Whittard of Chelsea (the tea and coffee retailer) sold by Ernst & Young to private equity immediately after their appointment as administrator. This business had 130 retail stores and more than 1000 staff.

The Insolvency Service (the UK's equivalent of ITSA) 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.'* [6]

The UK's insolvency regulatory bodies have issued a guidance note to insolvency practitioners which sets out the basic principles and essential procedures which insolvency practitioners must comply with when they undertake a pre-pack.

That's right, the UK government has sanctioned pre-pack sales and issued a guidance note to accountants and lawyers to assist them undertake pre-packs.

Statement of Insolvency Practice 16 has been adopted by each of the United Kingdom's regulatory 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.[7]

The SIP16 is not a definitive statement of law, but insolvency practitioners are liable for disciplinary action by their respective regulatory trade body if they fail to comply with the guidelines.

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."*[16]

During the eight years pre-packs have been used in the UK, some research into the process has been undertaken which is summarised below.[17]

Particulars	Pre-pack sale	Insolvency sale
All employees transferred to new company.	92%	65%
Secured creditor return.	42%	28%
Average return (unsecured creditors)	1%	3%
Sale of assets to related party.	59%	52%

I think the key statistic from this table is 52% of all insolvency sales by a liquidator in the UK involve a sale of some assets to a related party.

It is my view that the UK model for pre-packs, is a commendable first attempt to get the process right, however, it could be refined and improved if the following modifications were adopted.

Firstly, in the UK, the business is not openly advertised for sale. Instead, it is commonplace for the business to be sold in secret. This approach is a mistake. A justification for this approach is that almost all companies have exhausted their lines of credit and cash reserves before they approach a liquidator seeking advice. An administrator will only trade an insolvent company if the cash flow during the trade on period is positive, there is certainty as to the value of the assets which are to be sold, or there is an indemnity for trading losses.

Any liquidator will tell you that, when a VA commences:

1 Customers stop paying their debts, withdraw credit and supply.
2 Employees flee. This is a particularly bad scenario when a company has a high dependency upon a small group of skilled employees.

I suspect it is for these reasons that the UK approach has sought to avoid the sale of assets by a publicly advertised process. The UK approach ensures that the business will continue to trade up until the date of its sale. It is clear that a sale, by way of a limited marketing exposure, offers the following benefits:

1 It preserves the goodwill of customers;
2 It retains staff;
3 It avoids the personal exposure of voluntary administrator particularly the OH&S obligations which terrify liquidators;
4 It avoids funding a trade on administration, which is always difficult and therefore avoids significant liquidator/voluntary administrator fees;
5 It eliminates the costs of an auction/formal liquidation sale, which are significant.

The UK legislation has considered these pros and cons and formed the view that a secret sale is better than no sale.

Creditors have criticised this aspect of the process, suggesting that the realisation may be improved through wider marketing.

I contend the second material defect of the UK pre-pack system is that the administrator works with management to organise the sale. Thereby, the administrator in waiting, will help management with:

1 Valuations of the business;
2 Discussions with prospective buyers;
3 Obtaining the support of secure creditors and suppliers;
4 Setting the sale price and terms of the contract for sale.

When all the details are agreed and a formal agreement is ready to be executed, the formal appointment of the administrator is then attended to.

The problem here is that the administrator who put together the deal also has the responsibility for checking to see if the sale realised market value on behalf of creditors. There is an inherent conflict of interest in the two roles. There can be no doubt that management will enjoy the expertise of an administrator or pre-pack expert. Selling an insolvent company is a specialist role and only a few have knowledge and experience to do the job well, but a liquidator should only sit on one side of the fence, ideally, the administrator should be appointed by creditors to preserve and protect the creditors position and specifically prosecute the directors and advisors who fail to realise market value from a sale.

In Australia, the IPA's Code of Conduct states that the administrator can only charge for pre - appointment work if court approval is obtained and the work is necessary for the administration.

There is also IPA prohibition for accepting an appointment if there is a continuing professional relationship with a client, which is defined to include a relationship that exceeds two months' work. The Corporations Act (The Act) prescribes that the liquidator is disqualified from acting if he/she is a creditor of the company. Finally Section 420A of the Corporations Act ("the Act") contains the duty of care that controllers must exercise when utilising a power of sale.

It's clear that in Australia, the roles of helping management and the roles of scrutinising a sale will be attended to by two different parties.

Moving to the Spanish jurisdiction, their Insolvency Act was amended by Royal Decree 3/2009, which created a pre-insolvency negotiation period to enable a pre-pack plan to be developed.[8]

In New Zealand, the Companies Act 1993 was recently amended. The explanatory material indicates the legislation implicitly recognises that the use of phoenix arrangements does not counter to stakeholder interests. It suggests many phoenix situations are legitimate and operate to promote the interests of creditors of the insolvent entity through lower transactions costs and higher sale price as the business is sold as a going concern.[9]

So let's recap. The rest of the world uses pre-packs but in Australia we pretend they don't happen.

The first pre-pack in Australia?
The February 2010 issue of CPA's *In the Black* journal credits accountants Deloitte and lawyers Blake Dawson as implementing Australia's first pre-pack when they sold the owner of the 250-year-old Royal Doulton fine china manufacturer, Waterford Wedgewood Group.

Deloitte sold the Australian operations of this company on the first day of their appointment in January 2009. Some 450 staff were moved sideways as part of a $1 billion worldwide restructure.

Blakes stated "What we did was examine relevant law, worked out what would comply with the law before obtaining senior legal advice that would, if need be, satisfy a court".[5]

Deloitte and Blakes ran the pre-pack from start to finish. They stated that "Australia has much tighter and more stringent legal framework [than the UK and the US] but in the right circumstances and with absolute transparency for all stakeholders, pre-packs can make commercial and compelling sense."

This view was supported by lawyers Baker & McKenzie and liquidators Korda Mentha in March 2009 when they stated "the legal infrastructure exists to permit pre-packaging and the market environment might now be right for pre-packaged transactions to become more prevalent."[21]

Whilst Deloitte and Blakes might enjoy the credit from "being party to the first Australian pre-pack", the reality is that pre-packs are common in Australia.

Throughout the twenty years that I have practised insolvency I have known many "reconstruction specialists", lawyers who "re-engineer", "rebirth" and "phoenix" companies. If you want to know who these parties are, I invite you let a creditor initiate a winding up application against you. The resulting requisite advertisement will see at least half a dozen specialists call you and offer "a rescue plan" at a price you can afford.

I suspect pre-packs and specialists who trade in them in one form or another have been around for as long as the concept of limited liability, which goes back to 1855.

Definition of Phoenix
You recall that the traditional definition of a phoenix relates to the mythological bird, which at the end of its life, burns and then rises from the ashes.

Defining precisely what constitutes fraudulent phoenix activity is inherently difficult. This was noted by the Parliamentary Join Committee on Corporations and Financial Services in its report on corporate insolvency laws in 2004.[11]

The pursuit by ASIC's media department for a headline has resulted in ASIC repeatedly using the phrase phoenix activity as shorthand for director misconduct and breach of statutory and fiduciary duties. It fits into a by-line better. It's a catchy phrase. It's good media spin. But the result of ASIC's media activity is a blurring of the distinction between the legitimate process of selling a business and the illegitimate conduct of directors who breach their various obligations.[10]

One of the ATO's definitions of a phoenix is as follows:-
Fraudulent phoenix activity involves the evasion of tax and other liabilities such as employee entitlements through the deliberate, systematic and sometimes cyclic liquidation of related corporate trading entities.[12]

Cost of illegal Phoenix behaviour in Australia
In 1996, the then Australian Securities Commission (now ASIC) published its investigation into the problem of fraudulent phoenix activity in Australia. The report estimated annual losses to the Australian economy due to phoenix activities is between $670million to $1.3billion.[13]

In 2010, the ATO estimated that the current stock of suspected phoenix cases it is monitoring poses a risk to the revenue of around $600 million.[14] The ATO and therefore taxpayers in general are clearly the biggest loser from phoenix activity.

There can be no doubt that fraudulent phoenix behaviour as defined above must be eliminated by the legislators and the professionals who work in the area.

Current Legal Framework
So let's review the law that relates to pre-packs.

Despite ASIC's simplistic media hype and catchy newspaper by-lines, there is no prohibition of phoenix sales in the Corporations Act or in any other legislation.

If there was such a prohibition on the sale of assets from an insolvent company to existing management, assets would be abandoned and the loss to creditors exacerbated in a significant number of liquidations.[9]

Common Law
The common law requires directors to act in good faith, honestly and exercise their discretion in the interests of the company.[18] A director must exercise the powers conferred on them for the purpose for which they were conferred.

Corporations Act
Section 181 of the Corporations Act codifies the common law obligations by requiring a director to exercise their powers and discharge their duties:

- in good faith in the best interests of the company; and
- for a proper purpose.[18]

Misuse of position
Section 182(1) of the Act provides that a director must not improperly use their position to gain an advantage for themselves or someone else, or to cause detriment to the company.

Misuse of information
Similarly, s183(1) of the Act states that a person who obtains information because they are, or have been, a director of a company must not improperly use the information to gain an advantage for themselves or someone else or cause detriment to the company. [18]

Remedies against Directors
Specific remedies available against directors who engage in fraudulent phoenix activity include civil and criminal penalties under the Act. A number of general law remedies are available for breach of fiduciary duty by directors. They include injunctions and declarations, damages and compensation, accounts of profits, rescission, tracing and constructive trusts. Such remedies reflect the fiduciary relationship between a director and a company.

Civil penalty provisions
The statutory duties relating to good faith, use of position, use of information are known as 'civil penalty provisions'. A contravention of these provisions allows a Court to award pecuniary penalties of up to $200,000.

Criminal offences
A breach of a duty under the Act that constitutes a criminal offence attracts a fine and/or imprisonment.

Disqualification of directors
Section 206D of the Act provides that a director may be disqualified by the Court from managing corporations for up to 10 years if they have been involved in the failures of at least two corporations within a 7 year period and poor management or wholly or partly responsible for the insolvency of the corporation.

Section 79 Aiding and Abetting
Accountants and solicitors should be aware that pursuant to section 79 of the Act, professional advisers may be liable for breaches of the Act if they have aided, abetted or counselled the contravention by their client.

The codified fiduciary duties, such as sections 181, 182 and 183 provide that "a person who is involved in a contravention" shall be liable.

In 2009, solicitor Tim Somerville was held liable in the Supreme Court of NSW for the conduct of his directors when 6 unrelated clients attempted to fraudulently phoenix various companies in a process that ensured market value for assets was not paid.[23]

Mr Somerville had recommended a transaction and prepared or obtained documents necessary to carry out an improper transaction.

Asset transfers
ASIC can obtain injunctive relief under s1324 of the Act to stop this transfer and preserve the company's assets.

Uncommercial transaction
S588FB of the Act gives the liquidator the power to challenge "uncommercial transactions" Broadly, an uncommercial transaction is one that a reasonable person in the company's circumstances would not have entered into having regard to the benefits and detriments to the company of entering into the transaction and respective benefits to other parties to the transaction.

The Liquidators Role
Liquidators are not under an obligation to incur any expense unless there is sufficient available property to fund it. As a result, where a company is left with few or no assets, the liquidator is likely to perform only a perfunctory investigation.[18]

Phoenix crackdown by ASIC
In October 2005, ASIC was allocated $23million over four years by the Federal Government to establish the Assetless Administration Fund. A particular focus of the Assetless Administration Fund is to curb fraudulent phoenix activity. [18]

Insolvent trading
Section 588G of the Act imposes liability on a director of a company who allows the company to incur a debt at a time when the company is insolvent and at that time that the debt was incurred there existed reasonable grounds for suspecting that the company was, or may become as a result of incurring the debt, insolvent. An individual creditor has a secondary right to bring proceedings for compensation equal to the amount of "loss or damage". The amount of "loss or damage" is likely to include the amount of the debt and other consequential losses.

Our Corporations Act provides an incentive to directors to appoint an administrator and it discourages directors from pursuing restructures and taking reasonable and calculated risks to trade a company out of financial difficulty, but there certainly is no outright prohibition on pre-packs.

In the US there is no equivalent insolvent trading provision[21] that impinge on the directors from pursuing a pre-pack. In the UK, the insolvent trading equivalent is much more 'lenient' than the provisions in Australia. The directors will not be liable if they took every step to minimise loss to the creditors. Directors will, therefore, be able to pursue a pre-pack if they can satisfy themselves that a pre-pack will maximise the value of the company and therefore increase the benefit available to creditors.[19] This defence is known as the business betterment rule.

It is commonly stated that pre-packs occur minimally in Australia because directors are concerned about their exposure to insolvent trading and fiduciary duties.

Are the Insolvent trading laws effective?
In 2004, Alan Ramsay was part of a team who undertook a study of insolvent trading. The study sought to review every Australian insolvent trading case which the Courts had made a final determination.

The study dated back to the first insolvent trading legislation which was introduced in the Companies Act in 1961. Only 103 matters were identified as being available for this study. It's worthy to note that the current law in operation was introduced in 1993. In the 11 years that was available for this study to consider, only 19 matters were determined by the Courts.

During the 11 years prior to 1993, 61 matters were dealt with by the Courts under the previous regime of sections 556 and 592 of the Companies Code.

The results of the study show that 75% of insolvent trading cases are won by the liquidator/applicant.

In the cases where the defendant director/s were found liable for insolvent trading, and compensation was ordered, the mean amount of compensation ordered was $1.8m. However, this figure has been skewed by one particularly large judgement of $96,704,998. The minimum amount of compensation ordered in a case was $517.39. The median amount of compensation ordered was $110,597.62. (I think this excludes the $96m).

In over 64% of the cases, the compensation order was less than $200,000. Only 11% of the compensation orders were for over $500,000.[20]

Given there are approximately 8,500 insolvency appointments per annum, only two judgements a year with an average compensation order of less than $200K indicates that the insolvent trading regime is not an effective deterrent to insolvent trading. In my view, the insolvent trading provisions provide a very limited barrier to a director undertaking a pre-pack.

Most directors exhaust a company's resources before coming within cooee of a liquidator for help. Accordingly, the marginal value of the "extra" insolvent trading claim, compared to the existing insolvent trading claim, does not provide a deterrent for a director to keep trading an insolvent company for a few weeks while they undertake a pre-pack.

Directors must be discouraged from incurring further credit during a pre-pack sale process. Directors should be able to stand in front of creditors and say, “I formed the view that the company was insolvent on this date and incurred no further credit.” Affording priority to select creditors may resolve this issue, if legislative reform was made. Directors should be punished if they deliberately avoid their taxation and Corporations Act obligations.

Actual Legislative Reform

The 17 March 2010 Treasury Media Release “Immediate action to assist in crackdown on fraudulent phoenix activity” states in the first line, the Assistant Treasurer today announced immediate action by the Rudd Government to assist in the crackdown on phoenix activity. It then goes on to describe how the 1930’s process of lodging a bond to pay tax will be used again. This amendment will not slow down fraudulent phoenix behaviour. Australia has a self assessment system of taxation. The fraudulent conduct of dishonest directors will occur long before the ATO get an opportunity to ask for a bond.

If the security deposit reform is indicative of the immediate action by the Rudd Government, don’t hold your breath for anything meaningful. I note the Howard Government didn’t tackle the issue either. Insolvency was always lived on the fringe of the conscience of legislators. In time, I hope we will catch up to the rest of the world and make changes to our current legislative framework.

Conclusion

In Australia, we must reject the ASIC propaganda that a sale of an insolvent company’s assets to an existing management is always unconscionable.

Last year there were about 8,500 corporate insolvency appointments.[24] Approximately 15% of insolvent companies entered into a deed of company arrangement.[22] In my estimate, 1 in 4 companies will complete their deed obligations. It follows only about 5-10% of all companies that enter into a formal appointment under the current legislative framework realise the objective of saving a business.

Pre-packs offer a means to increase the survival rate for a business to continue to trade after an insolvency event.

Nicholas Crouch
8 April 2010

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25. See ITSA website. There was also some 36,479 personal insolvency appointments, including 27,503 bankruptcies.