A Platform for Recovery 2014

Dealing with Corporate Financial Distress in Australia: A Discussion Paper

Policy Development and Thought Leadership by the

Australian Restructuring Insolvency and Turnaround Association

October 2014

Executive Summary

ARITA believes that the existing Australian insolvency and restructuring framework not only serves the Australian financial system and economy well, but that it also stands up strongly in comparison to other regimes across comparable global markets. Nonetheless, there are several key areas for improvement and these are identified as the following:

Issue:	Lack of a restructuring culture in Australia
Solution:	Safe Harbour
Issue:	Value destruction as a result of entering external administration
Solution:	Informal Restructuring
Issue:	No 'Chapter 11' style regime to aid in the rehabilitation of large enterprises in financial distress
Solution:	Reworked Schemes/Voluntary Administration
Issue:	Critical supplier contracts automatically terminated on appointment of an external administrator, inhibiting formal restructuring
Solution:	Extension of moratorium to ipso facto clauses
Issue:	Maximising the chance of continuing the operations of financially distressed but viable small companies
Solution:	Micro Restructuring
Issue:	Maximising the return to creditors where companies with minimal liabilities fail
Solution:	Streamlined Liquidation
Issue:	Enabling viable businesses to continue, and maximise return for creditors, via a sale of business negotiated prior to the appointment
Solution:	Pre-positioning

Please note that Annexure A provides for a comparison table of major comparable markets' formal restructuring mechanisms and ARITA's position on these mechanisms.

We Value Your Input

The goal of this discussion paper is to create informed debate, which will inform our final policy paper.

To that end we'd like to hear your thoughts, comments and feedback on the issues raised.

1 Introduction

It is part of the good operation of market economics that some businesses and individuals will enter into financial distress. Indeed, this process is vital in ensuring the efficient allocation of capital. However, there are also significant human and social elements to financial distress of which a responsible society takes ownership.

The Australian regime for dealing with corporate and personal insolvency seeks to find a balance between these elements and to cover for various market failures that are naturally found in a market economy. We, as a society, make decisions about the framework that best suits our view of the balance we seek. That view changes over time and as a result of the economic cycle itself.

Australia's corporate insolvency regime has evolved to have a bias towards protecting the rights, and capital, of creditors i.e. those who provide the funding to allow businesses to undertake their activities with some level of financial gearing. In other markets, the bias may be viewed as being more towards the sustaining of the corporate entity itself, at the cost of the creditors' interests.

Australia's last major review of our corporate insolvency regime came in 1993 following the highly respected Harmer Report[1]. Its recommendations continue to underpin our current regime, including the voluntary administration framework. As with any regime, it is important that it evolves and is improved over time, especially as markets themselves change and evolve. Indeed, it's important to note that the economy itself has evolved substantially since that time.

2 About *A Platform for Recovery*

A Platform for Recovery is a discussion paper. It isn't a final policy document, though that is its ultimate evolution. The goal of this document is to create active and informed discussion of the issues and concepts that are raised. This will inform ARITA's final policy position.

Importantly, this paper does not go to the detail of specific legislative change. Rather, it identifies current issues or deficiencies in the current insolvency regime and proposes concepts, by way of law reform or best practice, to remedy these issues.

[1] Australian Law Reform Commission Report No 45: General Insolvency Inquiry 1988

3 ARITA's past policy and thought leadership work

Over the last several years ARITA has actively and thoroughly responded to many of the government inquiries into different aspects of insolvency law and practice. Outcomes from these by way of actual legislative reform have been limited.

The most significant of these have been in relation to our:

2007 insolvent trading submission where ARITA [then IPA] recommended a financial judgment rule – a safe harbour – in order to ameliorate the potential liability of directors for insolvent trading

2010 joint submission with Turnaround Management Association (TMA) and Law Council to Treasury, again on the safe harbour proposals

2010 response to the Australian Securities and Investments Commission's (ASIC) insolvent trading guide

2010 recommendation to the Productivity Commission on insolvency alignment reform

2011 response to the government's options paper on insolvency reform

2012 our further response to the government proposals paper on insolvency reform

2013 submissions to the Senate inquiry into ASIC

2013 our responses to the Insolvency Law Reform Bill 2013, and our continued input into 2014

2014 our submissions to the Financial Systems Inquiry.

In deference to these government inquiries, ARITA has variously organised discussion groups, conference topics and ARITA journal articles to promote an informed debate. In addition, in that period, in our journal, forums and our local and international conferences we have raised and debated other issues including directors' liabilities, tax penalties on directors, creditors' rights and engagement, reform proposals for receiverships, and the need for a government role in liquidations.

In particular, ARITA has funded significant empirical research studies, under its Terry Taylor Scholarship, one into the personal costs to liquidators of administering nil return administrations ordered by the court; the other into the dividend returns from DOCAs. Also, more statistics are now available from ASIC, and the Australian Financial Security Authority (AFSA), which confirm the generally poor outcomes of insolvency administrations.

4 Context

It is ARITA's view that the current regime has served Australia well. In particular, it has sustained economic value through a number of downturns and market shocks and major corporate failures. Importantly, during the GFC it should be noted that the Australian economy fared better than its competitors and that is reasonable to claim that our insolvency regime played a part in that – especially from credit provision and market confidence perspectives.

It's also notable that at times Australians tend to hold an idealised view of how other markets operate. We see the success but gloss over some of the failings. ARITA believes that we should carefully and scientifically analyse recovery and insolvency regimes elsewhere to see what may operate better than we have and learn from those approaches, however, a notion that we can simply transplant other systems here fails to acknowledge our own unique circumstances and ethos.

Informed by our past consideration of a wide spectrum of insolvency law reform issues, and by the experience and knowledge of ARITA and its members, we are now offering our view on reform of the Australian restructuring and insolvency regime.

ARITA's view is not whether change is needed, but that change and reform is needed, for the regime to improve its social and economic outcomes. We necessarily accept some of the current legal and practice structures in place in Australia and do not wish to suggest the impossible or impractical; for example, we are content to maintain the separate laws for personal and corporate insolvency.

At the same time, we do say that fundamental changes are needed, in particular in the need for greater emphasis on restructuring outcomes.

It has been put to ARITA in the past that 'evidence' is needed in order to consider reform of aspects of our insolvency laws. While we have gathered some evidence, it is also the case that much is not available, nor readily extracted, given the low levels of information about our insolvency regime. That the Financial Service Inquiry Interim Report had to rely on a 2000 Productivity Commission report on insolvency statistics is indicative of that. However, we ourselves are informed by the considerable experience and views of our members. Law reform can proceed on such an intuitive basis, backed by experience and informed input.

The Australian regime could currently be described as one with a strong bias towards preserving creditors' rights. Some other jurisdictions have more of a bias towards the preservation of the ongoing nature of organisations in financial distress. There are significant arguments around where the balance is appropriately set between these two approaches, and that that balance may alter dependent on where an economy's performance may be trending.

5 Aims of insolvency law

We accept the fundamental principles of and aims of insolvency law are to[2]:

- provide an equal, fair and orderly procedure in handling the affairs of insolvent debtors to ensure that creditors receive an equal and equitable distribution of the debtor's assets - the pari passu (equal sharing) principle
- provide procedures and processes for dealing with an insolvency with as little delay and expense as possible
- ensure that administrations are conducted in an independent, competent and efficient manner
- provide mechanisms which allow for treatment of the affairs of insolvents before their position becomes hopeless
- provide procedures which enable both debtors and creditors to be involved in the resolution of the reality of insolvency
- ascertain the reasons for the insolvency and to provide mechanisms which allow for the examination of the conduct of insolvents, their associates and the officers of corporate insolvents, and
- ascertain whether any offences have been committed by insolvents or their associates with a view to those offences being prosecuted.

These last two go to support the maintenance of the integrity of the insolvency process and of 'commercial morality'.

The reality is however that many of those aims are not being met. We measure our own proposals by those principles and aims, and suggest that they are better met by our new structure, or at least, that our proposals are more worthy of consideration than any acceptance of the status quo.

We therefore positively encourage and invite responses not only from our members, but also accountants, lawyers and financiers, the regulators and from government.

6 ARITA's policy aims

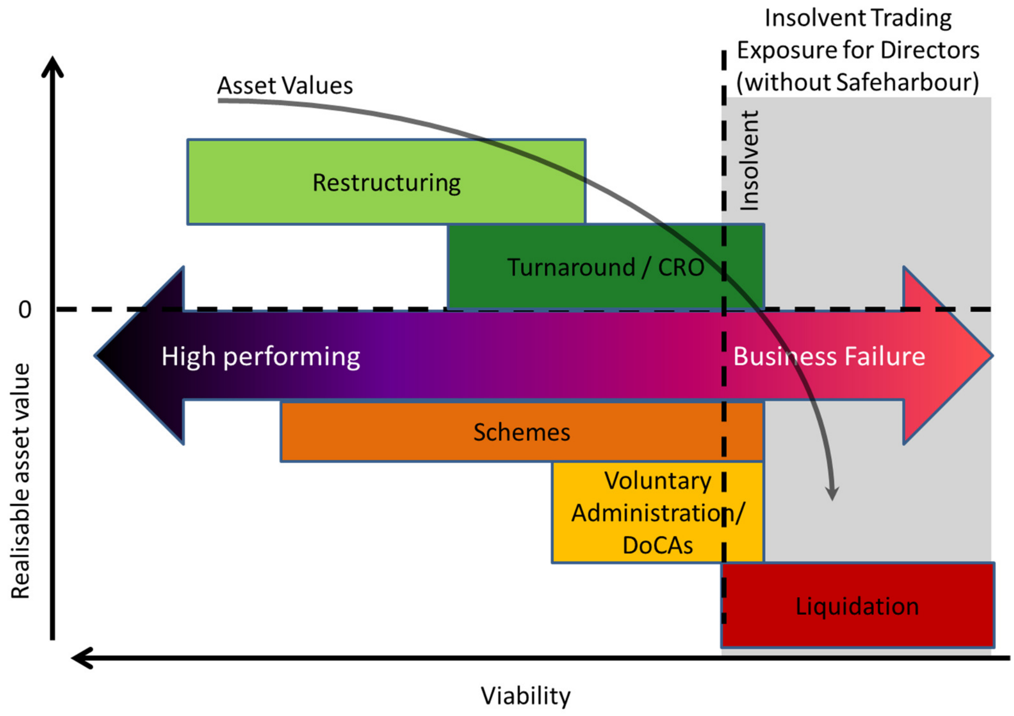
ARITA proposes an alternative regime to address the financial decline and potential termination of businesses.

We have a number of purposes in mind in proposing this, guided by our series of principles as to how the regime should operate. The principles are based on the accepted aims of insolvency law as discussed above. The regime should:

[2] The list is adapted from the Harmer Report ([33]) and the Cork Report ([198]).

- support the maintenance of the viability of good businesses that have otherwise found themselves in or are heading towards financial distress, with the minimum requirements of these businesses being that they have good financial systems and controls, are tax compliant, are compliant with other regulatory obligations – corporate, WHS, environmental, product safety etc - and demonstrate good corporate governance
- recognise the value to the economy of sustaining continuous employment for employees involved in viable organisations facing financial distress
- recognise that, as a micro-economic principle, capital should be recycled from non-performing businesses to performing businesses and that some element of business failure is a necessary and appropriate mechanism in ensuring an efficient and productive economy
- encourage or allow the prevention of the terminal insolvency of a failing but potentially viable business
- encourage and allow directors and management and independent, qualified and experienced financial and insolvency advisers, to assist in the recovery a viable company from financial distress
- to that end, provide a safe harbour from potential later claims, subject to certain requirements
- otherwise support the preservation of a viable business as a going-concern, including to allow the business to continue to have the benefit of existing contracts and leases
- require the interests of existing and new creditors to be taken into account, but at the same time recognise their responsibilities to attend to their own interests
- do so at a cost in proportion to the value and potential of the business
- require and allow any resolution of the company's financial distress to be dealt with as quickly as possible, consistently with the interests of creditors and of the company
- provide for the prompt assessment and orderly disposal of a failed business recognising that there is a cost to delivering this service
- accept that the nature and size of company businesses is extremely variable – from one director micro businesses, through SME businesses, to large enterprises, with a management structure and a board of several independent directors
- have regard to international precedents in the UK, US, New Zealand, Canada and elsewhere, and our on-going assessment of them, and
- provide proper remuneration for its practitioners, and not require its practitioners to do work or incur expenses without recompense.

The distinction between high performing and distressed companies and the impact on asset values over the viability spectrum is depicted below.



Value v Viability Diagram

7 The structure of 'a platform for recovery'

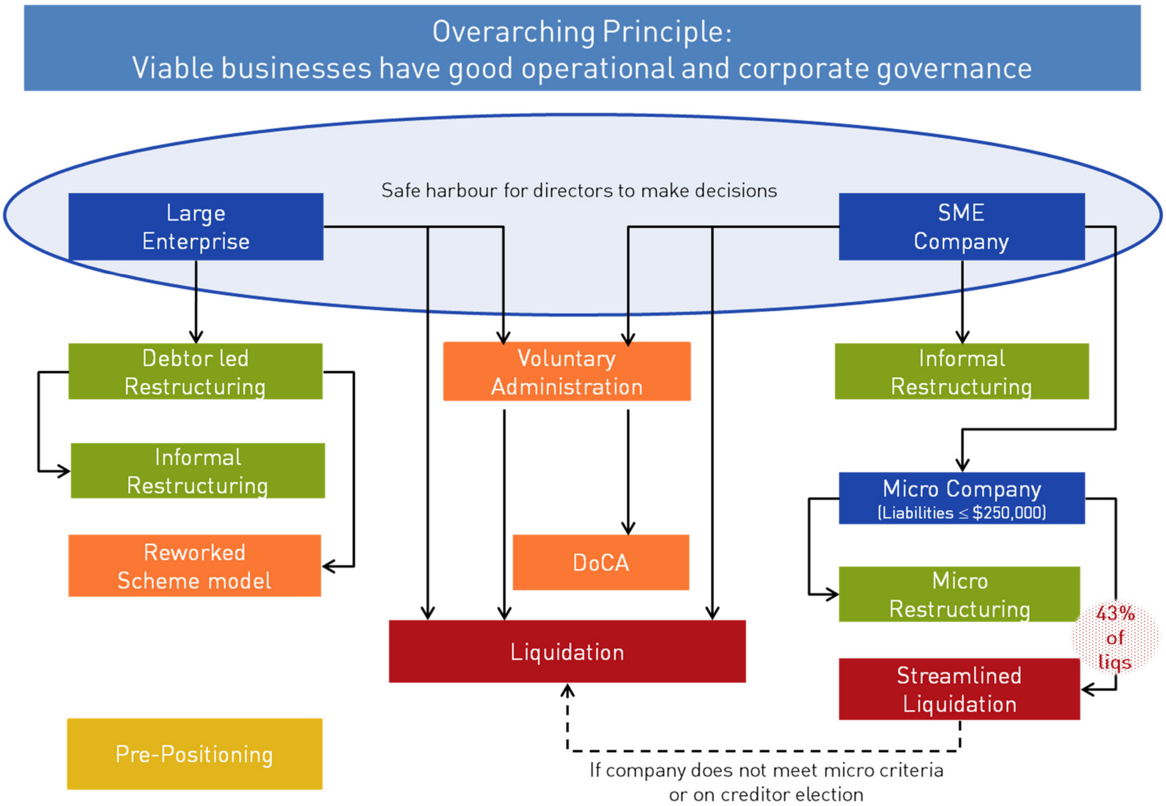
In preparing this paper we identified current issues, or deficiencies, in the current insolvency regime and proposed solutions to those issues. A foundation of our thinking is that the current 'one size fits all' approach to dealing with companies in financial distress is flawed. For example, such an approach does not take into account the scale of societal impacts of insolvencies in large enterprise collapses compared to small and nor does it take into account the differences in governance between large and small entities.

To that end, we conceive that there are three framework approaches required:

- Large Enterprises
- Small/Medium Enterprises (SMEs)
- Micro Companies (Liabilities less than $250,000).

Partnered by Chartered Accountants Australia and New Zealand and CPA Australia, ARITA is currently co-sponsoring empirical research being conducted by leading academics Jason Harris from UTS and Trish Keeper from Victoria University (NZ) on SME insolvency. This work is running concurrently with the consultation on this discussion paper and will be used to hone policy in this space at its completion.

The below overview provides a summary of the proposed reform concepts developed by ARITA based on the detailed three approaches above and the belief that size distinctions are required to better achieve the aims of Australian insolvency law.



8 Restructuring and a safe harbour

Issue	• Lack of a restructuring culture in Australia
Solution	• Safe Harbour

Much of what we propose requires there to be some deregulation of any laws that may impede restructuring, in particular the laws that impose on directors, and potentially their advisers, liability for insolvent trading.

There has been significant debate about this in recent years, to which ARITA has contributed, by way of submissions and through encouraging member and community debate. We are keenly aware of the issues and the arguments on both sides. In particular we are aware of the need to balance the rights of existing and on-going creditors of the company, who may suffer through insolvent trading, against the opportunities for the business to be restructured and the consequential benefits that may bring, including to those creditors.

It is said, and it has been raised as recently at the Financial System Inquiry Interim Report[3], that the threat of liability for insolvent trading serves to cause some directors to seek the protection of the voluntary administration regime too readily, rather than allowing those directors to continue to make genuine efforts to reverse and resolve the company's distress. Whether there is 'evidence' of that is problematic, from our members' perspective. But we do nevertheless consider that the liability for insolvent trading does exist in the minds of many directors and their advisers, but this does depend on the size of the company and the nature of its directors.

In that respect, we are also aware of the fact that our insolvency regime pays little regard to the obvious differences between large and small enterprises, and their respective directors and the directors' motivations. That difference is particularly relevant when considering the duties of directors.

Large companies most often have professional directors with little personal involvement in the fate of the company, beyond their duties to it as directors. They may tend to be risk averse in what is often referred to as the insolvency twilight zone in order to preserve their professional reputation and minimise their personal liability. They may be more readily prompted to invoke a formal insolvency appointment in order to avoid any risk of liability for insolvent trading.

[3] The Financial System Inquiry 2014 (Murray) Interim Report, released 15 July 2014

In contrast, small companies most often have directors who are also owners and guarantors of the company's liabilities, and they do not necessarily have the same 'professional' reputation to preserve. Theirs is more a business and commercial focus. Accordingly, in the insolvency twilight zone, they have everything on the line and tend to be comparably large risk takers. The threat of insolvent trading and of breach of directors' duties is far less.

We have addressed this difference in what is a large and threshold issue in this debate. We do not suggest separate insolvent trading regimes. Rather we offer an amelioration of that regime, but only to those directors who can show a satisfactory level of good corporate and financial judgment in the conduct of the company's operations generally and in the lead up to its financial distress.

In the current debates, this is typically expressed in terms of the need for a business judgment rule.

Insolvent trading laws[4] are intended to make directors act to prevent a company from incurring a debt if the company is insolvent at the time the debt is incurred, or becomes insolvent as a result of incurring the debt. Directors who trade whilst the company is insolvent face civil liability for debts incurred, which can be substantial and criminal prosecution, which can result in imprisonment.

It is our view that these laws do not work as intended for the following reasons:

1. In the case of larger companies with directors that are independent of the owners of the company (or listed companies), directors are generally educated and informed of their obligations, duties and risk of personal liabilities. They are also concerned about their reputation of being associated with a 'failed' company. As such, when a company is in financial distress, they are more likely to want to take steps to appoint an administrator to end the potential of insolvent trading liability, rather than 'risk' an informal restructure even if the company could potentially be turned around. Thus the insolvent trading laws act as a deterrent to restructuring attempts, even when a restructuring may be in the best interests of the creditors and the company. In this situation, there is an inherent conflict for directors between protecting themselves from personal liability and acting in a way which is in the best interests of the company and creditors.

2. In the case of SMEs where the directors are also generally the owners of the company, the directors' personal financial affairs are usually inexorably related to the financial affairs of the company and once the company is in a state of financial distress, the directors may well be too. With nothing left to lose, but a lot to gain if the business is able to continue, the distant threat of liability for insolvent trading is not enough to prevent the directors from continuing the business until there is nothing left to continue with[5]. Thus arguably, the insolvent trading laws do not act as an effective deterrent to reckless trading, particularly in the SME sector.

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[4] Primarily s 588G of the *Corporations Act 2001*

[5] ASIC statistics support this with 61.1% of companies in external administration having less than $10,000 in assets and 40.1% having less that $1 (Report 371 Insolvency Statistics: External Administrators' Reports for the period July 2012 to June 2013).

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3. It is inherently difficult for directors to assess the insolvency of their company in real time. Whilst under law a company is either solvent or insolvent, in reality a company can teeter on the edge of insolvency for some time and determining whether any business of even moderate size is insolvent is difficult unless it is clearly insolvent – even by an experienced insolvency practitioner.

4. Historically insolvent trading actions are difficult to prove and expensive to pursue. The reality that there are limited or no assets in a large number of administrations means that insolvent trading claims are unlikely to eventuate, particularly in SMEs where the claims are likely to be at the smaller end. Furthermore, asset protection strategies employed by directors and the fact that secured creditors and a number of trade creditors will hold personal guarantees from directors, means that often directors are unable to meet any compensation orders if an insolvent trading action is proved against them. We do recognise however that the threat of an insolvent trading action can result in out of court settlements in liquidations and payments under deeds of company arrangement to prevent further action being taken, resulting in benefits for the creditors.

It is clear that there is significant doubt as to whether the insolvent trading laws are achieving any of their objectives, but may instead be preventing directors from undertaking restructuring efforts in situations where that may be in the best interests of the company and creditors. It is ARITA's view a business judgement rule for insolvent trading (commonly referred to as a 'safe harbour) needs to be provided to facilitate directors being able to undertake restructuring efforts in appropriate circumstances.

The US regime does not include a concept of insolvent trading, while the concept above is an element of UK equivalent.

Much work has already been done on what the terms of such a safe harbour should be[6]. ARITA's views have not largely changed since our 2010 Joint Submission with the Law Council of Australia and the Turnaround Management Association. In summary, we support a business judgement rule with the following elements, that the directors7:

- make a business judgement in good faith for proper purpose
- after informing themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate
- rationally believe that the judgement was in the best interests of the corporation
- the director has taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that

[6] The Minister for Financial Services, Superannuation and Corporate Law released a discussion paper on 19 January 2010 titled *Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration*. ARITA (then the IPA) made a submission jointly with the Law Council of Australia and the Turnaround Management Association Australia dated 2 March 2010 and we also made a supplementary submission of our own dated 18 March 2010. Copies of our submissions are available from the ARITA website.
[7] Taken directly from the ARITA (then IPA), Law Council of Australia and the Turnaround Management Association Australia joint submission dated 2 March 2010 in response to the discussion paper *Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration*

all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed

- the director was informed with restructuring advice from an appropriately experienced and qualified professional engaged or employed by the company, with access to all pertinent financial information, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time
- it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring, and
- the director took all reasonable steps to ensure that the company diligently pursued the restructuring.

Our joint submission put forward five principal reasons why there should be a safe harbour defence to insolvent trading liability:

1. the existing law, without any safe harbour, can impede or prevent proper attempts at informal workouts
2. the adverse effect of the existing laws on honest, capable directors, particularly non-executive directors
3. the focus of directors of a financially troubled company should primarily be (as it is everywhere else in many other comparable jurisdictions) on the interests of creditors
4. the existing insolvent trading law limits the options available to deal with financial distress, and
5. a safe harbour defence would promote the critically important policy objective of obliging directors to obtain early restructuring advice.

We see these principal reasons as continuing to apply.

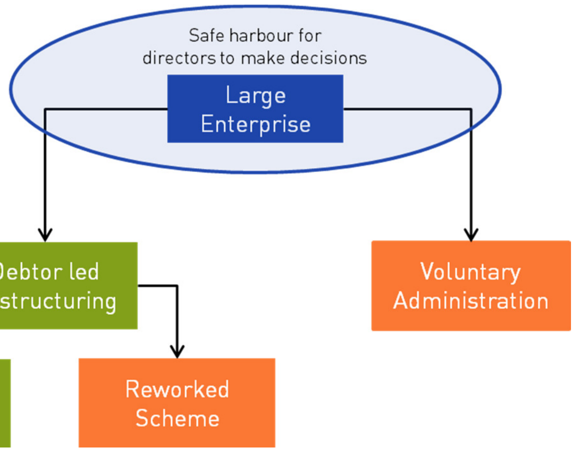
We note that directors should not be permitted to see the safe harbour provisions as a relaxation of their responsibilities. If anything, their responsibilities should be seen as being heightened during this period by the business judgement rule requiring positive and beneficial governance thresholds to be met before the rule can be used.

Consideration should also be given as to whether, in situations where the safe harbour protections are not met, the insolvent trading rules should actually be easier for a liquidator to prove in order to be able to obtain compensation for the affected creditors.

We are also strongly of the opinion that any strengthening of insolvency trading rules should also be supported by better regulation of directors. Consideration should be given to the implementation of a unique 'director identity number' (DIN) in order to more readily identify and monitor a director's involvement in companies. Presently there is no requirement to provide proof of identity when updating the corporate register maintained by ASIC of a director appointment. Safeguards, such as proof of identity requirements, could be put in place at the time of obtaining a DIN to mitigate the chance of inconsistent, misleading or false information being included on the corporate register.

As we have noted above, there is a spectrum of skills of directors and there is a need to ensure that *all* directors adequately understand the duties and responsibilities of their position, and the good corporate and financial judgment requirements that underpin our safe harbour proposal. We recommend that the successful completion of a suitably structured 'new director' course be required as a pre-requisite to the issuing of a DIN. This could be offered by ASIC as an online course.

9 Large enterprise framework



9.1

Issue	• Value destruction as a result of entering external administration
Solution	• Informal Restructuring

As previously discussed in Section 8, the safe harbour proposals are intended to provide an environment whereby, in appropriate circumstances, companies and their directors can undertake informal restructuring initiatives without the threat of insolvent trading liabilities. It is reiterated that eligibility for safe harbour protection is dependent on meeting specific criteria.

Furthermore, the safe harbour protections will mean that appropriately qualified and experienced professionals can be engaged in roles such as a Chief Restructuring Officer (CRO) without the potential for insolvent trading liability as a shadow director. This would allow greater scope in a CRO role than is currently possible due to the risks imposed under current legislation.

The protection provided by safe harbour would also provide more time to explore informal restructuring options where the solvency of a company may be in doubt.

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9.2

Issue	• No "Chapter 11" style regime to aid in the rehabilitation of large enterprises in financial distress
Solution	• Reworked Schemes/Voluntary Administration

ARITA recommends that the following enhancements be made to the current Scheme of Arrangement provisions (and in some instances, to the Voluntary Administration/Deed of Company Arrangement provisions in Part 5.3A) to better foster restructuring in Australia via statutory insolvency administration:

- implementation of ARITA's safe harbour proposal to remove the current necessity for a precursor administration in Schemes of Arrangements
- specific provision for application to the court for a scheme to have a standalone moratorium, including a restriction on the exercising of ipso facto clauses
- extension of the voluntary administration moratorium to ipso facto clauses (refer section 9.3 below)
- ability to recover director related antecedent transactions in Schemes of Arrangement (and Deeds of Company Arrangement) to reduce their misuse by directors to protect their own interests.
    - Directors to have the ability to contract out of this liability with the Administrator in both Schemes and Deeds
- statutory provision for the obtaining of financing via a Scheme of Arrangement (or Voluntary Administration/Deed of Company Arrangement)
- removal of related party voting in a Scheme of Arrangement (and Voluntary Administration/Deed of Company Arrangement) and reduction of voting requirements to majority threshold in line with those in a Voluntary Administration/Deed of Company Arrangement, and
- voting using purchased debts to be limited to the value of consideration paid, consistent with the current requirements in the *Bankruptcy Act 1966*.

In addition to the above, ARITA believes that consideration should be given to the implementation of a 'Schemes Panel' to replace the Court's oversight of Schemes of Arrangement. It is envisaged that this panel would operate in a similar manner to the Takeovers Panel and be a government regulated peer review panel.

ARITA recommends that further work be done to recognise and promote Schemes of Arrangement as a viable and functional reorganisation mechanism for large enterprises in the

Australian market. To achieve this, a general shift in the Australian environment from a focus on the return to creditors to the rehabilitation of businesses is required.

In considering the above concepts, ARITA reviewed and considered the following aspects of similar restructuring mechanisms in like economic markets (USA, UK and Canada):

- Main objectives
- Director liability
- Who is appointed/oversees the process
- Stay of proceedings, and
- Voidable transactions.

A detailed analysis of these considerations is provided in Annexure A.

In addition to the above, it is noted that consideration of the adoption of aspects of a US style 'Chapter 11' regime in Australia has been discussed in various forums over a number of years, including

- Senate Economics References Committee 'Inquiry into the Performance of the Australian Securities and Investments Commission' July 2014.
- Parliamentary Joint Committee on Corporations and Financial Services Corporate Insolvency Laws: a Stocktake August 2004.
- Corporations and Markets Advisory Committee 'Rehabilitating large and complex enterprises in financial difficulties Report' October 2004.

None of these reviews has recommended the implementation of a 'carbon copy' Chapter 11 regime in Australia. In 2004, the CAMAC Report into large enterprises found 'no compelling need, or intrinsic shortcoming in the VA procedure, which requires or justifies adopting Chapter 11 as an additional or substitute corporate recovery procedure for large and complex, or other, enterprises'[8]

Most recently the ASIC inquiry made this recommendation:

> **Recommendation 61**
>
> 27.52 The committee recommends that the government commission a review of Australia's corporate insolvency laws to consider amendments intended to encourage and facilitate corporate turnarounds. The review should consider features of the chapter 11 regime in place in the United States of America that could be adopted in Australia.

Given the extensive historical consideration of this matter, ARITA does not propose to revisit the question of the fulsome adoption of a Chapter 11 style regime. ARITA has given specific consideration of the current Australian Schemes of Arrangement process detailed in Part 5.1 of

[8] Corporations and Markets Advisory Committee *Rehabilitating large and complex enterprises in financial difficulties* October 2004

the *Corporations Act 2001* and aspects of Chapter 11, and other foreign restructuring mechanisms in developing our proposals.

9.3

Issue	• Critical supplier contracts automatically terminated on appointment of an external administrator, inhibiting formal restructure
Solution	• Extension of moratorium to *ipso facto* clauses

An ipso facto contractual clause allows one party to terminate a contract by reason only of the fact (ipso facto) of the insolvency of the other party. These clauses are found in the majority critical supplier contracts, franchise and license agreements as well as leases for land and equipment. Ipso facto clauses have played a pivotal role in the shutdown of major organisations that were in financial distress (examples such as the carrier contracts of One.Tel being terminated soon after the company entered voluntary administration resulting in One.Tel being unable to provide services to its customers, are obvious). It is ARITA's view that voluntary administrations are not as successful in restructuring businesses as they could be due to the fact that the moratorium in a voluntary administration does not extend to ipso facto clauses.

Under s 301 of the *Bankruptcy Act 1966*, ipso facto clauses are rendered void if the relevant obligor becomes bankrupt. However, there is no such prohibition in relation to corporate insolvency, and more particularly voluntary administration, under the *Corporations Act 2001*.

As a result, if a financially distressed but viable business that is reliant on essential contracts continuing enters into voluntary administration, it is likely that:

- contracts will immediately be terminated
- there will no longer be any business to restructure, and
- there will no longer be any value for creditors.

In some cases, directors may in fact be reluctant to place their companies into voluntary administration because of concern that this may result in creditors exercising their right to terminate under an ipso facto clause and in effect terminate the company's business. This delay may weaken the company's chance of financial recovery.

The justification for such a moratorium being extended to cover ipso facto clauses is to ensure that important contracts of the business are maintained such that goodwill is preserved while the company is under administration. This serves to maximise the chances of the company and its business continuing as a going concern or otherwise maintaining its value to third parties. This is currently not the case in Australia and the experience of our members is that where the business is reliant on maintenance of contracts, voluntary administration sees the swift demise of the business due to termination of these contracts.

The Harmer Report recommended that any contractual provision such as those discussed above be void against a liquidator or administrator[9]. The reasoning for the Report's recommendation was that there has been a similar provision in the *Bankruptcy Act 1966* (s 301) since 1968. The bankruptcy provision was recommended by the 1965 Clyne Committee on the basis that to permit such an agreement to be terminated merely because of insolvency may sometimes have the effect of depriving the trustee of a bankrupt person of an opportunity to deal with the property comprised in such an agreement to the advantage of the creditors[10]. The ALRC adopted that reasoning and considered that it should apply with equal force to a company and recommended legislation to bring this into effect[11]. It is ARITA's opinion that this position is still correct, including in the corporate insolvency context.

Voluntary administration provides a limited and temporary moratorium against ipso facto clauses in some types of contracts once a company enters voluntary administration. Section 440B restricts the rights of landlords, secured creditors, and others during the voluntary administration process, but not contracts generally. We see the need for a restriction on the right to exercise rights under all ipso facto clauses at least for the period of the administration, which is generally some few weeks, with court approval for any extension of that period generally required.

The law in favour of the validity of ipso facto clauses is inherently counterproductive and contrary to the spirit of the Part 5.3A regime. We consider that the law should apply in the same way to contracting parties, subject to court leave, and subject to distinctions as may be necessary between different types of contracts. In our view, in cases where such contracts are in issue, that would be a very significant improvement in the effectiveness of Part 5.3A.

The US has a prohibition against contractors terminating a supply contract when a company enters Chapter 11. This is one element of Chapter 11 that ARITA has consistently supported[12]. ARITA has long recommended the law in Australia adopt this US approach as one way of countering the reduction in value of a business on its entering insolvency.

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[9] ALRC 45, vol 2, s AT10. See also vol 1, paras 703 – 705.
[10] Clyne Committee Report, para 383.
[11] The recommended legislation was: Certain provisions in agreements to be void
AT10.
(1) Where a company is a party to an agreement (other than a charge) that contains a provision to the effect that, if the company commences to be wound up in insolvency or becomes a company under administration, then
  (a) the agreement is to terminate or may be terminated
  (b) the operation of the agreement is to be modified, or
  (c) property to which the agreement relates may be repossessed by a person other than the company,
the provision is void, unless the Court otherwise orders, as against the liquidator or administrator.
(2) This section extends to agreements made before the commencement of this section.
[12] ARITA's first submission regarding the need for a moratorium on ipso facto clauses was it submission (then as the IPAA) in April 2003 to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into Australia's Insolvency Laws.

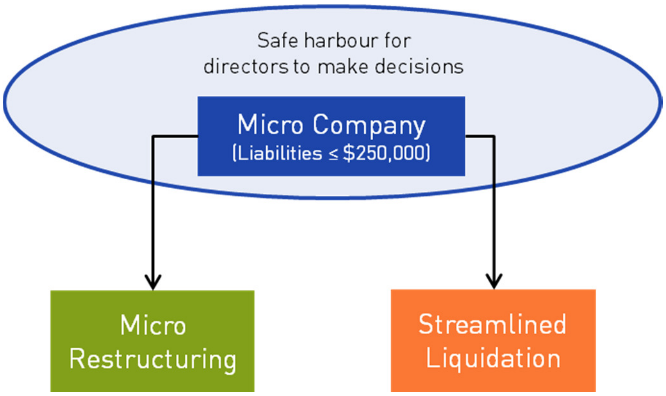
The UK is presently considering extending the avoidance of such clauses in telecommunications collapses[13], an area where our experience in Australia shows such a law is particularly needed.[14]

10 Small/medium enterprises, including micro companies

As mentioned earlier, ARITA has partnered with Chartered Accountants Australia and New Zealand and CPA Australia to co-sponsor empirical research on SME insolvency. This work is running concurrently with the consultation on this discussion paper and will be used to hone policy in this area at its completion.

Notwithstanding the specific SME considerations from the joint initiative, the ipso facto concepts detailed at section 9.3 above would equally apply to the SME market, although it is envisaged that this would more commonly be via a voluntary administration than a scheme of company arrangement due to the size of the enterprises.

The safe harbour concepts outlined in section 8 of this Discussion paper do not differentiate based on the size of an organisation and would also equally apply to SMEs and its subset of micro companies. We envisage that companies would engage advisers appropriate to their business size but we do not see this as a limiting factor for eligibility for the safe harbour protection.



Micro companies, as we have chosen to define them[15], form the vast majority of insolvencies in Australia. ASIC's statistics report that 43% of insolvencies have liabilities of less than $250,000 while some 40% of insolvencies are assetless[16] at the time of insolvency. In the case of assetless insolvencies, there are, by definition, no available funds to support the work of a liquidator and, in particular, to fund the investigations work of liquidators. The latter is of particular concern, with much anecdotal evidence that companies are often wound down to this point specifically to avoid investigations work. It is noted that ASIC operates an Assetless Administration Fund.

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[13] Continuity of supply of essential services to insolvent businesses, UK Government, Open Consultation, 8 July 2014, closing 8 October 2014.
[14] ARITA is working with the Communications Alliance in Australia to address this issue in the telecommunications sector.
[15] Less than $250,000 in liabilities to unrelated entities
[16] ASIC Report 371 *Insolvency Statistics: External Administrators' Reports* for the period July 2012 to June 2013

However, practitioners are placed in the invidious position of needing to undertake unfunded work in order to access this, with little certainty of it being made available at the end of that work

ARITA has previously supported research that reported on the extent of unfunded work undertaken by insolvency practitioners and valued it at $48 million per annum[17]. This is obviously unsustainable for the profession.

In recent times, there has been significant political discourse around the need to provide a 'streamlined' process for SME insolvencies. Given the lack of funding available for SME insolvencies, ARITA concurs that a reduced process option should be made available in certain circumstances.

For companies where the micro criteria is not meet or creditors elect for a creditors voluntary liquidation with the current investigation requirements, there should be more ready access for practitioners to an enhanced Assetless Administration Fund-style arrangement.

This is driven home by recent ASIC statistics that show that of the 10,073 reports submitted by practitioners in the last year, 7,218 identified misconduct by directors alongside 43% of all insolvencies having estimated liabilities of $250,000 or less.[18]

10.1

Issue	• Maximising the chance of continuing the operations of fincially distressed but viable small companies
Solution	• Micro Restructuring

Section 185C of the *Bankruptcy Act 1966* provides a mechanism for individual debtors who meet specific eligibility criteria to enter a binding agreement with their creditors to accept a sum of money that the debtor can afford, more commonly referred to as a Part IX Debt Agreement.

We propose that a similar mechanism be implemented to deal with micro companies. It is envisaged that this process would be more streamlined and cost effective than the compromise alternatives that are available under the existing Voluntary Administration/Deed of Company Arrangement provisions of the *Corporations Act 2001*.

Eligibility criteria to undertake a micro restructuring agreement would include:

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[17] *An analysis of official liquidations in Australia*, Amanda Phillips (ARITA Terry Taylor Scholarship Recipient), February 2013

[18] ASIC Report 412 Insolvency Statistics: external administrators' reports (July 2013 to June 2014) September 2014

- must meet the definition requirements for a micro company
- company must be insolvent, and
- not available to companies who, or companies whose directors, have previously done a micro restructuring agreement. Such protection would be available under our Safe Harbour proposal detailed at section 8.

Although we do not propose to go into operational detail in this paper, we would recommend that any micro restructuring mechanism would require:

- The company to prepare a Report as to Affairs (RATA) to be provided with the proposal[19].A Registered Liquidator to oversee the development and implementation of the proposal, possibly referred to as a Restructuring Monitor:
  - who examines and approves the proposal[20]
  - issues the proposal to creditors, and
  - may set fixed or other fee basis for creditor consideration and approval at same time as proposal.
- Creditors vote to accept or to put the company into liquidation:
  - no need for physical meeting, with resolution able to be considered by circulation
  - if they vote for liquidation then the company proceeds to liquidation immediately
  - related parties cannot vote, and
  - if debt is purchased then purchase only entitled to vote for amount for which debt purchased.
- An accepted proposal would be put into effect by the Liquidator/Restructuring Monitor and would be subject to the following provisions:
  - no requirement to call or hold further meetings
  - if debts to unrelated entities exceed $250,000 then appointment would automatically convert to a Voluntary Administration with full investigation and reporting requirements (if directors wish to continue to put a Deed of Company Arrangement proposal to creditors), or creditors voluntary liquidation (if there is no Deed of Company Arrangement proposal)
  - streamlined proofs of debt process for debts under $10,000
  - no tax clearance from Australian Taxation Office required where dividend is less than $25,000 (10% of maximum liability amount) or 10 cents in the dollar, and
  - a default longer than 6 months automatically results in the company being placed into liquidation.
- Creditors may apply set aside the proposal if there is a lack of full disclosure in the proposal or injustice provisions, similar to the current requirements in a Part IX Debt Agreement.

[19] S185D of the *Bankruptcy Act 1966* requires that a Statement of Affairs (the personal insolvency equivalent of a RATA)be given with a debt agreement proposal
[20] For Part IX Debt Agreements this is currently done by debt agreement administrators are not registered trustees. We propose that debt agreements for companies be undertaken by registered liquidators.

10.2

Issue	• Maximising the return to creditors where companies with minimal liabilties fail
Solution	• Streamlined Liquidation

The current requirements of Australia's liquidation processes impose a number of statutory reporting and process obligations on liquidators, which have the effect of increasing the costs of the liquidation and reducing, or eliminating, the return to creditors

We propose that, where a company meets the micro company criteria (i.e. liabilities to unrelated entities less than $250,000) the new streamlined liquidation process automatically apply.

A new streamlined liquidation process would differ from the current liquidation requirement as follows:

- removal of requirement to call meetings, report to creditors, undertake investigations into the company and officers' conduct and complete statutory reporting (e.g. s 533 report)
- expedited dividend process[21]:
  - Streamlined proofs of debt dealing process for debts under $10,000
  - No tax clearance required from the Australian Taxation Office where the dividend is less than $25,000 (10% of maximum liability amount) or 10 cents in the dollar, and
  - Streamlined advertising and notice requirements for dividends less than $25,000 (10% of maximum liability amount) or 10 cents in the dollar, and
- fixed fee set by government for this type of liquidation, no remuneration accounting or approval.

In order to protect the rights of creditors and the integrity of the regime, the streamlined liquidation process would incorporate provisions whereby:

- the liquidator would report to creditors on appointment and gives them the option of converting the streamlined liquidation into a full creditors' voluntary liquidation (i.e. where normal investigating and reporting obligations apply and remuneration of liquidator is given priority in the normal way)[22]

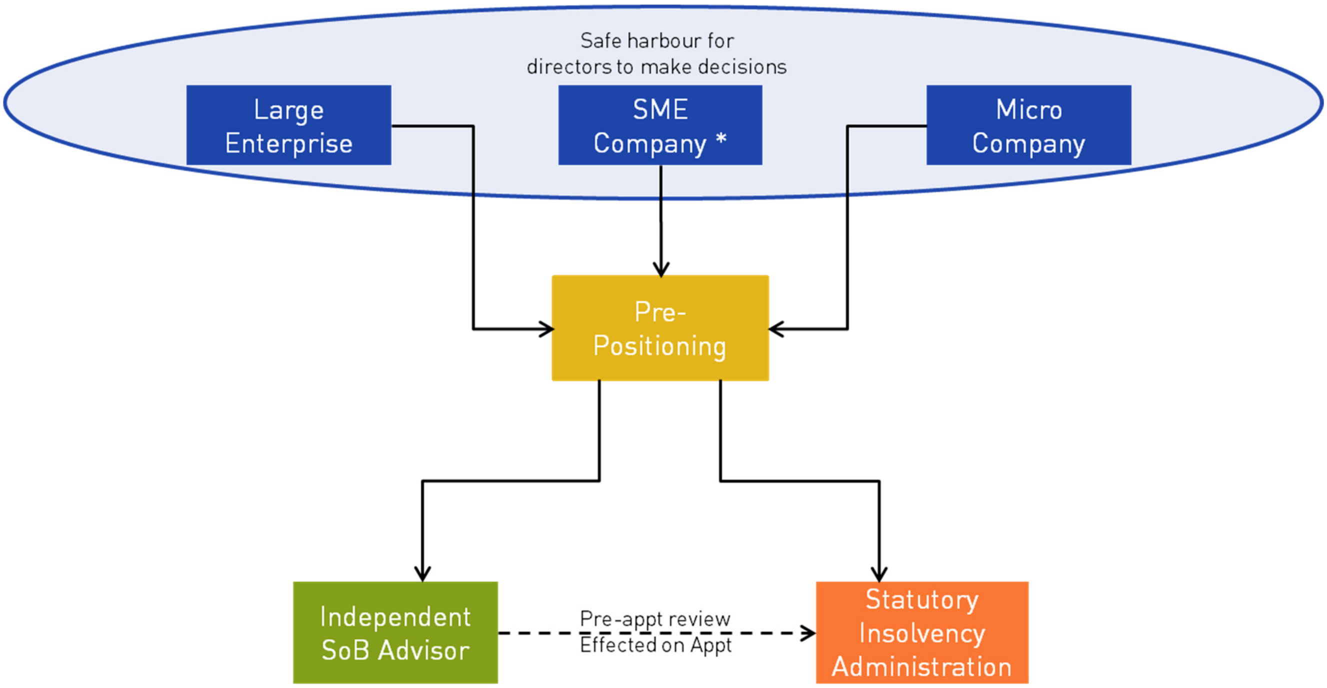
[21] Note that ASIC statistics show that of the 43% of liquidations with less than $250,000 of debt, 97% receive 0-11 cents in the $ dividend which should mean that the majority of these liquidations will fit within the streamlined process

[22] Section 545 of the *Corporation Act 2001* which provides that a liquidator does not have to undertake work if there is insufficient funds, would also apply

- if a majority of creditors (excluding related party creditors) vote for this to occur then it converts and the Liquidator does not have the power to convert to a full liquidation without this consent
- if the liquidator subsequently becomes aware of a matter which may warrant investigation, they can again seek creditor directions (including resolution by circulation, if appropriate) as to whether the liquidation should convert to a full liquidation, and
- if liabilities at any time in the process exceed $250,000 to unrelated entities the streamlined liquidation process would no longer be available and the existing creditors' voluntary liquidation requirements would apply.

11 Pre-positioned sales

Issue	• Enabling viable businesses to continue and maximise return for creditors, via a sale of business negotiated prior to the appointment
Solution	• Pre-positioning



As a general position, ARITA supports the restructuring and turnaround of viable businesses suffering financial distress. A key aspect of this is an economic and legal environment that supports business restructuring and turnaround. ARITA's safe harbour proposals are a fundamental part of developing that environment.

There has been some call to 'legalise' or promote UK style pre-packs within Australia as another restructuring / turnaround tool in the toolkit of the restructuring specialist.

As part of our consideration of what should be done to promote restructuring and turnaround in Australia, ARITA has given detailed consideration to whether a pre-pack style arrangement should be introduced into Australia.

For a number of reasons, including independence, whether the sale is for value and the lack of creditor involvement, which are discussed in more detail at Appendix B, we do not consider that a UK pre-pack process would be suitable for Australia. However, we see that there is a role for 'pre-positioning' in the Australian insolvency context. What do we mean by pre-positioning? Pre-positioning is work done prior to a statutory insolvency appointment, with directors taking advantage of the safe harbour protections, subject to meeting the criteria for eligibility, to undertake an orderly wind down of the company's operations – that is a well-managed process where assets may be realised for market value in a non-distressed sale – prior to making a formal insolvency appointment. Directors may obtain the assistance of advisors, including insolvency practitioners, during this process.

The main differences between the UK's pre-packs and ARITA's proposed pre-positioning are:

- Any advisor retained by the directors in the pre-positioning phase cannot subsequently be appointed in any formal insolvency administration. This is consistent with the current and appropriate, independence requirements for insolvency practitioners in Australia.
- Any sales that occur in the pre-positioning phase must be for value and would be subject to review in any subsequent statutory insolvency administration.
- Any sale of assets undertaken during the statutory insolvency administration, where the terms of sale were negotiated in the pre-positioning phase, would be subject to review by the external administrator prior to being effectuated and the external administrator would be subject to the currently existing statutory and professional requirements regarding the sale of assets.

It is ARITA's view that consideration should be given to restricting the sale of company assets/business to related entities during this pre-positioning phase. Rather where the sale of a business or the assets to a related entity is contemplated, and the company is insolvent, that sale must be undertaken under the control of an independent insolvency practitioner through a statutory insolvency regime – either a VA (subject to ARITA's recommendations for improvements), a Micro restructuring (refer to section 10.1 above) or liquidation.

ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

Annexure A - Restructuring Mechanisms – Overview

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Main objectives	A reorganization plan proposed by a debtor to keep its business alive and pay creditors over time	A regime whereby the principals of a company (owing its creditors in excess of $5 million) and its creditors are brought together under the supervision of the court to attempt a reorganization or compromise or arrangement under which the company could continue in business	A procedure that allows a company: • To settle debts by paying only a proportion of the amount that it owes to creditors. • To come to an arrangement with its creditors over the payment of its debts.	Binding, court-approved agreements that allow the reorganisation of the rights and liabilities of members and creditors of a company	Binding, court-approved agreements that allow the reorganisation of the rights and liabilities of members and creditors of a company	Provide a mechanism to maximise the chances of a business continuing in existence or at the very least, provide a better return to creditors	Generally the main objectives of the different mechanisms are substantially similar. However it should be noted the USA and Canadian models reflect the prioritisation business rehabilitation over the ultimate return to creditors, which remains a key focus in Australia. Promotion of Schemes as a viable and functional reorganisation tool, requiring a shift in the current focus.

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Director liability	No exposure to insolvent trading offences	Initial stay orders can be sought indemnifying directors so that those who are important to the restructuring will stay during the restructuring period	Offences for trading while insolvent – duty/responsibility to prioritise the interests of creditors		Offences for trading while insolvent	Offences for trading while insolvent	Early intervention would increase the likelihood of return to creditors – safe harbour provisions required where company acts in good faith to reorganise and meets criteria. Current necessity for precursor administration. Safe harbour provisions necessary to make Schemes a more useful restructuring tool for large enterprise

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Who is appointed/ oversees the process	Debtor in possession appointment - overseen by Bankruptcy Court Lawyers & other professionals (Insolvency Professionals) engaged, usually separate set of lawyers/IPs per stakeholder group: • Debtor company • Secured creditor(s) • Creditor committee • Employees	Debtor in possession appointment - overseen by monitor	Directors remain in control but supervised by nominee (IP)		Optional to appoint a Scheme Administrator, but if one is appointed they must be a Registered Liquidator or a person approved by the Court, i.e. CRO, (cannot be a director/manager/snr manager/employee) Debtor led administration - Scheme Administrator oversees scheme and does not run the business	Registered Liquidator – known as Voluntary Administrator /Deed Administrator	

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Stay of proceedings	As prescribed by law	Within the court's discretion Expressly prohibits enforcement of ipso facto clauses	If requested by the directors to the court	No moratorium but Scheme doesn't commence until approved by the Court after the meeting of creditors. This means that the Scheme needs to operate within the protection of another insolvency process to be used to restructure an insolvent company (due to insolvent trading laws).	Currently no moratorium but Scheme doesn't commence until approved by the Court after the meeting of creditors. This means that the Scheme needs to operate within the protection of another insolvency process to be used to restructure an insolvent company (due to insolvent trading laws).	As prescribed by law but does not extend to ipso facto clauses	Ipso facto clauses can have a detrimental impact on the ability of a business to continue (e.g. telecommunication businesses). The extension of the VA moratorium to ipso facto clauses would help preserve business viability. Application to the Court for Scheme to have standalone moratorium (incl. restriction on termination of contracts) so that undertaken outside of a VA/Liq process, but still have protection from creditor recovery action and preserve value

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Voidable Transactions	Unfair preferences: • Undo a transfer of money or property within 90 days before filing petition (subject to defences) • Transfers to relatives, general partners, directors/officers within 1 year before filing	Preferential transactions and transactions at undervalue recoverable	Not available	Not available	Not available	Not available	Extend director related payment recoveries to Schemes and VA/DOCAs– reduces misuse by directors to protect their own interests, but can be contracted out of
Financing	Debtor-in-possession allowed	Debtor-in-possession allowed	Not available		Subject to approval of the Court	Has been considered and approved by the Courts but no specific statutory provisions	We accept that cases have allowed third party financing in a VA/DOCA, but we believe there should be a recognised process for prioritising funding to enable a restructure via a Scheme or VA/DOCA.

Annexure B

What are 'pre-packs'?

A pre-pack administration occurs when an administrator sells the business at or soon after his or her appointment, often to the existing owners/directors. All the preparatory work for the sale is carried out in advance of formal administration and before the creditors have been told about the failure of the business.

UK Experience

The Graham Report into pre-packs has recently been released in the UK. This is timely to our consideration of pre-packs for Australia. The information in the Graham Report has been utilised when developing this paper.

In the UK pre-packs are undertaken through the Administration process, whereby an administrator can be appointed by the company, the directors or by the holder of a qualifying floating charge out of court. Immediately after appointment, the administrator transfers the business for a pre-agreed price without the need for a creditors' meeting to be called to consider the terms of the deal. The administrator then distributes the proceeds of sale. If there is no money for unsecured creditors, the administrator can immediately file for the dissolution of the company. If there are funds for the unsecured creditors, the administrator will usually be appointed as liquidator to make the distribution to unsecured creditors and then dissolve the company. In either situation, there is no independent insolvency practitioner undertaking a review of the steps taken.

Differences between the Australian and UK markets

A very different insolvency approach exists in the UK and Australia, where in the UK, in an Administration, if a creditor is 'out of the money[23]' they are essentially precluded from any decision making about the assets. In Australia, under current government policy, creditors (even those unlikely to receive any dividend) are entitled to be involved in the insolvency process and have a voice. Certainly the proposed Insolvency Law Reform Bill from 2013 proposes to further increase the role and powers of unsecured creditors in insolvency processes. ARITA has questioned whether this is a position that we should seek to lobby to change to align Australia with the approach taken in the UK. However, the view that we have taken is that it is appropriate for creditors to have a role in insolvencies as it is their money that has been lost and effectively the assets of the company are held for their benefit once the company is insolvent. Whether creditors wish to exercise that right and participate in the process is up to them; however it is important that they have that right.

Unlike Australia, the UK no longer has a receivership mechanism. Often pre-packs undertaken through an Administration are effectively quasi receiverships in that the only creditors receiving a payment are secured creditors as the remaining creditors are out of the money. Therefore it is largely the secured creditors driving the decision making during the pre-

[23] The creditor is not going to receive a dividend – the debt is worthless. Where the administrator believes that no payment will be made to the unsecured creditors, there is no requirement for a meeting of creditors to be held at all in the administration.

pack. ARITA does not propose the abolition of receiverships in Australia at this time, therefore Receiverships work as a viable formal insolvency appointment for secured creditors. Alternatively, in the proposed safe harbour environment[24], secured creditors would be able to work with their clients to restructure or turnaround the business (which may involve a sale of the business for value) in a safe environment.

Independence of insolvency practitioners appointed in a formal insolvency in Australia has a test of real and reasonably perceived independence which is incompatible with the UK system of practitioner involvement in the sale process prior to appointment. Whilst the UK also has independence requirements, it is a system of threat identification and management which allows for practitioner pre-appointment involvement in the pre-pack process.

Key risks with UK pre-packs

- Lack of independence of the practitioner involved – usually it is the same practitioner advising pre-appointment and appointed in the subsequent formal insolvency.
- Lack of transparency in the pre-pack process and guidance such as SIP16 does not seem to resolve creditor concerns in respect of this issue.
- Valuations are of dubious value to the process with sales made at the same $ as valuation particularly when sales are to related parties, and valuations often being only of real assets and not taking into account intangibles such as value of the business name, goodwill, intellectual property.
- Sale for undervalue as the business may not be appropriately marketed.
- Sale to a related party, often with deferred consideration – resulting in relatively high failure rate of the 'newco' (92 out of 310 connected sales in the UK study had failed within 36 months – 30%; increasing the 37% failure rate if there was also deferred consideration).
- The UK experience indicates that in 60% of pre-packs there was no distribution to unsecured creditors, so therefore in the majority of pre-packs there is no benefit of the process to unsecured creditors.
- Potential insolvent trading while the 'pre-pack' is being put together, though this is not as great a risk as if it were under the current Australian insolvent trading regime.

Key reported benefits

- Protects value of the business.
- Saves jobs.
- Pre-packs are cheaper than a formal insolvency process where the sale is undertaken.

Some comments on the UK Pre-packs report

- Pre-packs represent only 3.5% of insolvencies in the UK.
- Approximately 65% of all pre-packs resulted in sales to related parties.

[24] Subject to the company meeting the criteria to take advantage of the safe harbour protections.

- 60% of all pre-packs result in no dividend to unsecured creditors (though there may have been a payment to secured creditors).
- 86% of pre-packs with a sale to related parties result in no dividend to unsecured creditors (though there may have been a payment to secured creditors) – so essentially pre-pack sales to related parties return no value to unsecured creditors.
- 25.5% of all pre-pack sold businesses fail within 36 months of the purchase.
- Where it is a related party sale, this increases to 30% failure with 36 months (17.5% of business pre-pack sold to unrelated parties fail).
- Where there is a related party sale and deferred consideration the failure rate within 36 months increases to 37%.
- Deferred consideration generally results in higher failure rate with 36 months (nearly 39% failure).
- Of the 121 purchasers that failed within 36 months, 1/3 entered into a rescue procedure.

Alternatives in the Australian environment

1. Sale before formal insolvency – if the sale is 'for value' to a related party or via an arms-length sale during the pre-positioning phase, it will not result in the sale being challenged or recovery action by a subsequently appointed insolvency practitioner. It will however, provide opportunity for an independent review of the transaction with the benefit of creditors in mind. Practitioner appointed must be different to any practitioner advising the directors/company regarding the pre-appointment transaction to ensure independence in the review of the transaction.

   An issue with this approach is potential director liability for insolvent trading during the period of marketing and attempting to sell the business. ARITA's safe harbour proposal will resolve this issue for directors that meet the criteria to take advantage of the safe harbour protections. If the safe harbour proposals are introduced, it is difficult to argue that this will not provide sufficient protection for directors to allow them to achieve a sale. The safe harbour proposals provide protection for directors that are able to make informed decisions based on proper financial records and are getting appropriate professional advice. Should a business that cannot meet the basic requirements of proper financial records be able to be moved into another corporate entity, particularly where it is being controlled by the same parties?

   There may be an argument to say that related party sale (or restructure) should have to be undertaken through an appropriate formal insolvency process – see 2 below. Note that the UK has proposed legislation to ban related party pre-packs if the Graham report recommendation of the creation of a pre-pack pool to review related party sales is not implemented.

2. Formal insolvency administration – either VA (subject to ARITA's recommendations for improvements) or a Micro debt agreement (refer ARITA's SME thought leadership paper). If a sale to an entity controlled by the same parties is contemplated, then this can be achieved via the current VA regime or via the proposed new micro enterprise debt agreement regime. One argument is that where it is intended that related parties/the

company wants an opportunity for an insolvent business 'to have another go' it is appropriate that it is the creditors who should make the decision as to whether this is acceptable. When a company is insolvent, it is, in reality, the creditors' assets that are being dealt with and it should be their decision as to what happens with them.

Can the Australian options have the same benefits without the risks of the UK pre-pack system?

Benefit	Does the Australian pre-positioning alternative have the same benefits?
• Protects value of the business	Yes • Sale can occur pre-appointment as long as it is for value. • Safe harbour protections for informal restructuring/sale of business. • Improved VA process and new Micro Debt Agreement proposal.
• Saves jobs	• Business sales or restructures are able to be achieved with outside or within formal insolvency regime – saving jobs wherever there is a viable business to be saved.
• Pre-packs are cheaper than a formal insolvency process where the sale is undertaken	• Sale of business not limited to being undertaken via a formal insolvency. Where for value not subject to challenge. • Safe harbour proposals support directors where criteria met to support informal restricting/sale of viable businesses.

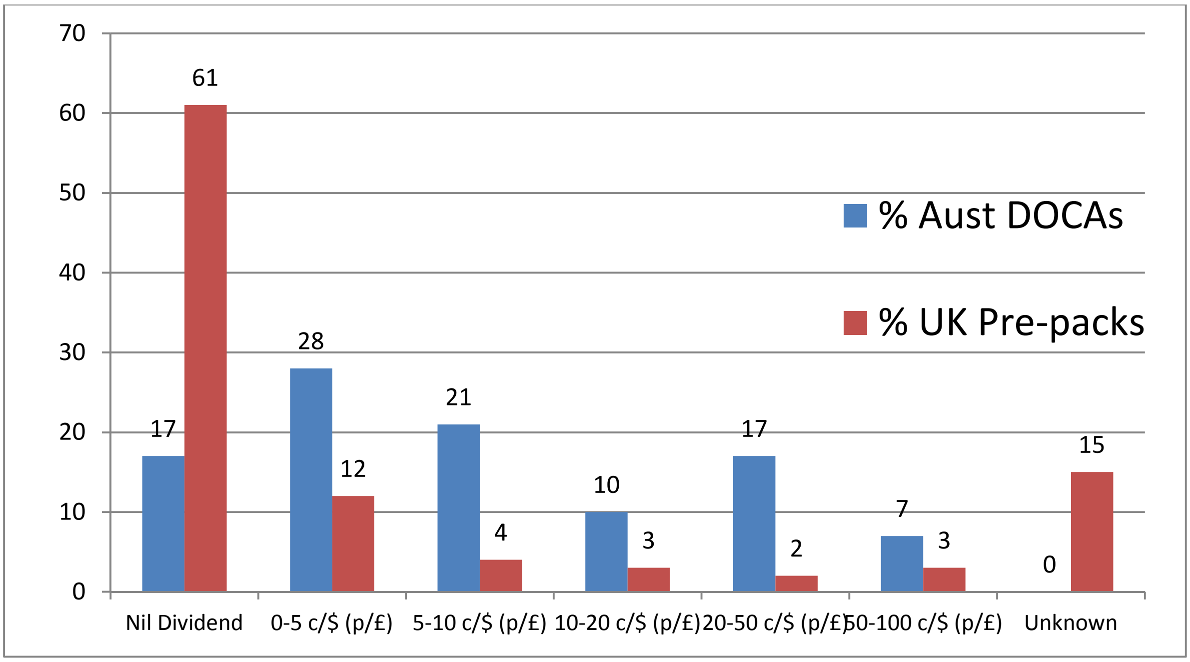
Risk	Does the Australian pre-positioning alternative address the risk?
• Lack of independence of the practitioner involved – usually it is the same practitioner advising pre-appointment and appointed in the subsequent formal insolvency.	• Independence of practitioner maintained as not involved in any pre-appointment sale or negotiation.
• Lack of transparency in the pre-pack process and guidance such as SIP16 does not seem to resolve creditor concerns in respect of this issue	• Independent practitioner will be reviewing any pre-appointment sales, or • creditors will have a right to have a say in any sales/restructuring occurring through a formal insolvency process.

Risk	Does the Australian pre-positioning alternative address the risk?
• Valuations are of dubious value to the process with sales made at the same $ as valuation particularly when sales are to related parties, and valuations often being only of real assets and not taking into account intangibles such as value of the business name, goodwill, intellectual property	• Independence of the insolvency practitioner undertaking the sale process (must comply with common law obligations), or • independent practitioner reviewing the sale that was undertaken prior to appointment – will have power to overturn sale if not for value.
• Sale for undervalue as the business may not be appropriately marketed	• Independence of the insolvency practitioner undertaking the sale process (must comply with common law obligations), or • independent practitioner reviewing the sale that was undertaken prior to appointment – will have power to overturn sale if not for value.
• Sale to a related party, often with deferred consideration – resulting in relatively high failure rate of the 'newco' (92 out of 310 connected sales in the UK study had failed within 36 months – 30%; increasing the 37% failure rate if there was also deferred consideration)	• Independence of the insolvency practitioner undertaking the sale process (must comply with common law obligations) and will assess the virtue of the offer. Creditors will also have a chance to be involved in the process, or • independent practitioner reviewing the sale that was undertaken prior to appointment.
• The UK experience indicates that in 60% of pre-packs there was no distribution to unsecured creditors, so therefore in the majority of pre-packs there is no benefit of the process to unsecured creditors	• The role of creditors in Australia means that a DOCA proposal is unlikely to be accepted if creditors don't get offered some type of return (refer to comparison table below). • Independent practitioner reviewing the sale that was undertaken prior to appointment – will have power to overturn sale if not for value.
• Potential insolvent trading while the 'pre-pack' is being put together, though this is not as great a risk as if it were under the current Australian insolvent trading regime	• Safe harbour proposals will resolve this issue for directors that can meet the criteria.

Compare returns in Australian DOCAs vs. UK Pre-packs

The Australian voluntary administration/deed regime is criticised for providing low returns to creditors. Mark Wellard has recently undertaken research for ARITA under the Terry Taylor

Scholarship on returns from DOCAs in Australia. The results of this research were released around the same time as the Graham Report into Pre-packs. Subsequent to the release of his findings, Mr Wellard has prepared an addendum which compares the returns in pre-packs with the returns in DOCAs. The findings are as follows:



It should be noted that the returns in Administrations in the UK not involving a pre-pack sale are similar to that for pre-packs[25].

Mr Wellard made the following observations in his addendum:

Australian DOCAs and UK pre-packs cannot purely be compared on a 'like-with-like' basis due to inevitable differences in the features and nuances of the respective regimes and legal frameworks operating in each jurisdiction. For example, I understand that significant or 'substantial' secured creditors (charge holders) are more prevalent stakeholders in UK pre-packaged administrations due to the inability of a UK secured creditor to appoint an 'administrative receiver' (the UK equivalent to Australia's 'receiver and manager'). In Australia, secured creditors invariably 'stand outside' a DOCA (indeed, in the cases of Australian SME companies it appears that often there is no substantial charge holder involved at all).

Notwithstanding the imperfections of jurisdictional comparisons, it does appear that Australian DOCAs perform relatively well for unsecured creditors in comparison with the UK 'pre-pack' procedure.

[25] The Wolverhampton report concludes section B2.5 by stating that '[t]he data available does not show a substantial difference between the levels of distributions to unsecured creditors, as a proportion of overall debts, made in either pre-pack or trading administrations.'

This demonstrates that although the regime in Australia could be improved to better facilitate the restructuring and turnaround of viable businesses, it may not be as unsuccessful as first thought.