Sewell & Kettle

A Second Chance Strategy For An Insolvent SME: Alternative Pre-Pack Insolvency Arrangements Whitepaper

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Overview

Insolvency issues for SMEs

Directors and advisors of SMEs

Liquidators of SMEs

Voluntary administrators of SMEs

Restructuring of SMEs

OVERVIEW

1. What is a pre-pack insolvency arrangement?

The market for insolvency services is rationalising and particularly with small-to-medium sized enterprises, lower cost and less disruptive methods for rescuing insolvent businesses are becoming the focus of the profession. The pre-pack insolvency arrangement is an opportunity to achieve a business rescue without the cost and disruption of a voluntary administration.

A pre-pack insolvency arrangement is an instrument for rescuing an insolvent business through a legally binding transaction either before or after the formal appointment of an insolvency practitioner. It is an alternative to using voluntary administration for rescuing an insolvent business from a liquidation fire sale.

The methodology of using a private treaty to rescue an insolvent business without principally resorting to a formal insolvency appointment is not new. Illegal private treaty arrangements, originally “bottom of the harbour scheme” and now “phoenix activity” contrast with legal pre-pack insolvency arrangements.

The terms “pre-pack”, “pre-pack insolvency” and “pre-pack arrangement” are interchangeable but “pre-pack insolvency arrangement” will be used in this discussion paper. This discussion is focused on legal pre-pack arrangements and helping directors and entrepreneurs to avoid litigation and fall out from poor and illegal advice that leads to phoenix activity.

The essential preconditions for a pre-pack insolvency arrangement are that a business is insolvent, and that the business has an intention to restructure their affairs to rescue it and give directors a second chance. Pre-packs also apply to sole traders and partnerships but these vehicles for trading have been largely overtaken by the corporate form (i.e. a proprietary limited company). Sole traders and partnerships are only prevalent now in industries where professionals are prohibited from trading through corporate entities.

A pre-pack insolvency arrangement has the following elements:

- A company *(Oldco)* is insolvent;
- Oldco*’s* business is transferred for commercial consideration to a related entity *(Newco);* and
- The transaction between Oldco and Newco results an optimal outcome for stakeholders.

There are two types of pre-pack insolvency arrangements:

The transaction takes place after Oldco is placed in insolvent administration (i.e. liquidation or voluntary administration); or

1. The transaction takes place before Oldco is placed in insolvent administration.

The pre-pack insolvency arrangement is not widely used in Australia but it has been recognised as a valid methodology by courts, the insolvency profession and government

bodies. The pre-pack insolvency arrangement was acknowledged as a legitimate restructuring transaction in a recent government report into phoenix activity:

> *"A genuine business failure where the business has been responsibly managed and subsequently continues using another corporate entity is a legitimate use of the corporate form".*[1]

2. Who should read this White Paper?

The purpose of this White Paper is to inform small-to-medium sized enterprise *(SME*) directors and their professional advisors about pre-pack insolvency arrangements and the consequences of poor restructuring advice. The White Paper is also a challenge to phoenix activity promoters whose poor advice has expensive consequences of personal liability for tax debts and determination of market standing for rebirthed businesses.
SMEs are businesses employing less than 200 people, these businesses represent 99.7% of businesses in Australia. SMEs have unique needs because they have small shareholdings (i.e. usually an entrepreneur or a family), they are sensitive to professional fees and often have poor business processes and records. SME professional advisors need to have a whole business approach in identifying obstacles including personal, operational and financial difficulties that their clients face. This information should then be utilised when developing a rescue strategy.

This whitepaper is relevant for a range of people involved with SMEs, including:

- SME directors;
- Accountants;
- Insolvency practitioners;
- Property and transactional lawyers;
- Family and estate planning lawyers; and
- Insolvency lawyers.

This is not a "tips and traps guide" or "7 things you must do to implement a pre-pack rescue". There is no single accepted methodology for planning and implementing a pre-pack insolvency arrangement because of the complexities of tax law, corporate law and market realities faced by SMEs.

3. What is a pre-pack voluntary administration?

A pre-pack voluntary administration occurs when there is an arrangement (i.e. a restructuring plan) planned before the appointment of a voluntary administrator. The arrangement is likely to include the transfer of business assets from Oldco to Newco, but the transaction may be completed either before or after the appointment of the voluntary administrator.
The primary difference between a pre-pack voluntary administration and a 'regular' voluntary administration is that in a pre-pack arrangement, the planning and negotiation of the business transfer takes place prior to the appointment of the voluntary administrator.

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[1] Action against fraudulent phoenix activity, November 2009, Treasury Australian Government, page 1

Valuations would have already been obtained, contracts drafted and the sale price agreed before the appointment of a voluntary administrator in a pre-pack scenario.

In a 'regular' voluntary administration, the voluntary administrator takes over the management of the insolvent business and only begins sale or payment negotiations with stakeholders after their appointment. After assessing the viability of the business the administrator decides whether to continue trading under the business during the administration period, or close it down. There is a second meeting of creditors that decides the future of the business and whether creditors will accept a compromise or put the company into liquidation.

The deed of company arrangement (*DOCA*) is the primary binding instrument between the creditors, directors and the voluntary administrator when any compromise maybe made with the directors. A DOCA proposal is subject to a vote of creditors, and therefore needs creditor support.

The obvious benefit of a pre-pack insolvency arrangement is that the directors of the insolvent business retain control of the business throughout the insolvency process. This is the case of the pre-pack transaction executed before the appointment of a voluntary administrator or liquidator. On the other hand, if the pre-pack transaction is not executed before the appointment of a voluntary administrator it is unlikely that the voluntary administrator will finalise the transaction without the approval of creditors.

In a "regular" voluntary administration the voluntary administrator will evaluate any purchase offer of the business and will be unlikely to approve a sale before it is considered by the second meeting of creditors.

4. Who is suitable for a pre-pack insolvency arrangement?

The two key characteristics of an insolvent SME that may be suitable for a pre-pack insolvency arrangement are:

- That there is a serious commercial issue with the goodwill in a business being damaged by a formal appointment scenario; and
- The costs of a voluntary administration are uncommercial.

The goodwill of a business is the value of a business over and above the price of all the assets of the business. Accountants would say that goodwill amounts to the excess of the "purchase consideration" (i.e. the money someone is willing to pay to purchase the assets of the business) over the total value of the assets. If a formal appointment (i.e. a liquidation or voluntary administration) is likely to damage goodwill or otherwise significantly reduce a potential purchase price of the business this is a valid commercial justification for a pre-appointment transfer of the business of Oldco.

In a liquidation scenario the liquidator is under no obligation to continue trading a business, and if they do they are at personal risk if a liquidation trade-on suffers a loss. As a result of liquidation the business may be terminated or put on hold, significantly impacting if not eradicating the goodwill of the business. The liquidation of a company is likely to result in a

total loss in the goodwill of a company. To avoid such a scenario, a liquidator does have the right to licence the business as a means of ensuring its continuity.

It is likely that the damage to goodwill value will have already been done by notification of the liquidation to the suppliers and customers. An ipso facto clause gives a customer or supplier of a company in administration or liquidation the right to terminate a contract based upon insolvency. In Australia an ipso facto clause of a contract is not illegal, unlike in the United States. This means that upon a formal insolvency appointment the customers and suppliers of Oldco have the right to stampede and the effect would reduce the goodwill value of Oldco.

There is currently very little empirical research into the costs of voluntary administration but it may be observed however, that the costs of a voluntary administration are on the increase. It may be expected that a voluntary administration for an SME will cost between $50,000 and $200,000. It is often uncommercial to appoint a voluntary administrator to a company, particularly in the case of microbusinesses with 1-4 employees and SMEs, as the costs could consume all the value in the business solely in administrator's fees.

Pre-packs are quicker sales where the insolvent company (i.e. Oldco) can usually continue trading through Newco without going through a voluntary administration process. This would enable the company to retain the value of their brand, their employees and key customers.

INSOLVENCY ISSUES FOR SMES

5. What are SMEs and why are they important?

A small-to-medium size enterprise (*SME*) is any business that employs up to 200 employees. The Australian Bureau of Statistics (*ABS*) reported in its count of Australian businesses that as at June 2014 there were 826,393 employing businesses and of these:

- 571,176 had 1-4 employees (microbusinesses);
- 197,412 employed 5-19 employees (small businesses); and
- 51,688 employed 20-199 employees (medium businesses).[2]

The relative size of SMEs, compared to large corporations and government entities, belies the importance of the segment to the economy. SMEs contribute one half of private sector employment and one third of private industry value-add.[3]

The ABS also reported that microbusinesses had a 9.7% exit rate and a 14.6% entry rate, indicating a very active economic space.[4] Although "exit" does not necessarily mean all those businesses had become insolvent we can assume that a significant proportion were insolvent or at least unviable.

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[2] Australian Bureau of Statistics, 2014, 8165.0 Counts of Australia Businesses, Including Entries and Exits, June 2010 to June 2014 at page 21.

[3] Australian Treasury, Australian Small Business, December 2012, report published online at www.treasury.gov.au

[4] Australian Bureau of Statistics, 2014, 8165.0 Counts of Australia Businesses, Including Entries and Exits, June 2010 to June 2014 at page 21.

97.4 percent of micro businesses are wholly Australian owned,[5] meaning they are more reliant upon a smaller number of customers and members of their local community. In such a case, the community is likely to feel the effects more heavily in the disruption of SME's, with a high chance the disruption impacts on them directly, being owners and employees of such entities.

The small-to-medium sized businesses are the backbone of the economy, it is important for professional advisors as key clients to understand their importance.

6. What financial and operational issues do SMEs face?

SMEs have historically suffered from higher costs of capital and after the Global Financial Crisis *(GFC)* the problem was exacerbated. Before the GFC (2001 to 2008) SMEs paid a premium of at least 1.5% above the interest rates paid by large businesses, since this time the spread has jumped to at least 2%.[6] SMEs are reported to most commonly seek finance to maintain short term cash flow or liquidity.[7]
Access to finance is a critical issue faced by SMEs and anecdotal evidence suggest the banks are avoiding lending to SMEs overall.

The root causes of insolvency issues that are faced by SMEs today are:

- Australia's slow paying culture; and
- Poor management.

The objective of the next section is to explore the root causes of SME insolvency. A discussion paper released by the Federal Government regarding the Prompt Payment Protocol asserted that 90% of small business failure is caused by poor cash flow.[8] It showed that Australia has a national culture of paying suppliers slowly in the business-to-business (*B2B*) context. The research compares Australia and New Zealand's B2B debt payments and found that there is a marked difference between the times for these debts to be paid, on average:

Australia 54.1 days v NZ 43.1 days.[9]

This is not so much a legal issue but a micro-economic reform issue because SMEs are particularly vulnerable to cash flow crunches. The best example is the Building and Construction Industry which has historically had the highest rate of insolvencies. To remedy

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[5] Australian Treasury, Australian Small Business, December 2012, report published online at www.treasury.gov.au at page 31.
[6] Australian Treasury, Australian Small Business, December 2012, report published online at www.treasury.gov.au at page 61.
[7] Australian Treasury, Australian Small Business, December 2012, report published online at www.treasury.gov.au at page 34.
[8] Australian Government, Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education, *Australian Prompt Payment Protocol, Discussion Paper*, July 2013 at page 4.
[9] Australian Government, Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education, *Australian Prompt Payment Protocol, Discussion Paper*, July 2013 at page 10.

this, construction contracts with “pay when paid” terms for payment have been outlawed and subcontractor payments sped up through the Security of Payment legislation.[10]

Often the question is asked, what is the point of no return in the spiral to insolvency? The answer is chronic insolvency, winding up applications, Director Penalty Notices from the ATO, staff walking out the door, being put on stop by suppliers and deadlock between owners and/or management. These are all features of the spiral towards insolvency, however, these are symptoms rather than root causes of insolvency.

If we think like doctors about causes and symptoms, the research supports the proposition that poor management, the big project and overtrading are the most common root causes of insolvency.

Cause 1: Poor management

The bad news is that the prime cause of business failure is poor management.

Here is what to look out for as indicators of poor management:

- Refusal to seek or take advice: A director should look to advisors who have been through insolvency situations and understand the strategic issues that the business faces;
- Narrow-mindedness: Directors who only show interest in matters that concern their particular area of expertise or interest. Also directors that lack finance experience and/or do not have suitable financial advisory services at hand; and
- People skills: There is no need to have a business study accreditation or a great deal of emotional intelligence to establish hard-worked performance expectations. Down-to-earth, direct and goal-oriented managers are likely to get the most from their staff.

Cause 2: The Big Project

Entrepreneurs are likely to be optimistic. They may take on a big project without up-to-date financial information or reasonable forecasts. In this situation costs and timeframes are often underestimated and/or revenue is overestimated, more likely than not, leading to a cash flow crunch.

Cause 3: Overtrading

It is obvious to point out that business growth costs money (i.e. working capital) because additional funds are required to build the business before actual income from increasing revenue is received.

Overtrading is another major cause of business failure. Challenging targets are set for the business and employees but the cash flow effects of expanding the business is not properly estimated before execution.

[10] For example, *Building and Construction Industry Security of Payment Act 1999* (NSW).

Add predictable business risk event

If a business is already in a tight financial situation because it is overtrading, taking on too big projects, or is poorly managed, an otherwise predictable event may cause the business to fail. These risks are not likely to cause a healthy business to fail but may cause a vulnerable business to tip over. Unfortunately there is no way to prevent these normal business risks. Losing a big customer, having a key person in the business suffer ill health, economic downturn or an act of god (weather, war, etc.), are examples of these unpredictable events. The old rule of thumb is that a business needs 3 months of business expenses saved in order to be covered in the event of a predictable business risk event.

Add creative accounting

When a business is failing it can be tempting to get 'creative' with accounting. This is one symptom of impending business failure. Creative accounting can often be an unintended result of trying to reframe the problem.

Beware if any of the following symptoms occur:

- Delay in producing financial statements;
- Continued payment of dividends (i.e. drawings) by relying on debt rather than retained earnings;
- Cutting expenditure on routine maintenance;
- Starting to treat extraordinary income as ordinary income and vice versa;
- Changing ownership title of main assets in the business;
- Valuing assets at inflated figures;
- Meeting company debts out of the Director's own pockets; and
- Valuing stock of dated products at the current market selling price rather than at cost.

Watch out for tax debts

The Director Penalty Notice *(DPN)* regime is a big challenge that is adversely affecting entrepreneurs and directors of SMEs. The ATO is training their staff and automating their processes to issue DPNs regularly. The ATO are "punching" a lot of these out through data matching and document automation systems. A DPN allows the ATO to pierce the corporate veil meaning that directors may be personally liable for tax debts resulting from unpaid Superannuation Guarantee Charge (*SGC*) and unpaid PAYG contributions.

Since 2012 directors of SMEs are held to be personally liable for PAYG and SGC contribution liabilities that are both unpaid and unreported for three months. The personal liability accrues irrespective of whether the ATO issues a DPN, the DPN now however crystallises the date that the personal liability is due to be paid. Personal liability cannot be avoided if the unpaid liability was unreported for three months. Directors will also be unable to avoid personal liability under the director penalty notice by placing the company into voluntary administration or having it wound up.

7. What is the legal meaning of insolvency?

Section 95A of the Corporations Act 2001 (Cth) (*the Act*) defines "insolvency". Under the Act a company is insolvent if it is unable to pay its debts as and when they become due and payable. It is known as a "cash-flow test" of insolvency, because a company may have more assets than liabilities on their balance sheet but are considered to be insolvent because they cannot sell their assets fast enough to satisfy their debts as they become due and payable. What is required is that a company have a chronic shortage of working capital, rather than be suffering from a temporary lack of available cash.
The "cash-flow test" is preferred over other tests of solvency, as it is a more accurate test of the viability of a company's business. Even if a company has an excess of assets they may not be able to sell them in time to satisfy the debts of the company. On the other hand, a company with substantial debts may be able to trade its way out of difficulties if the debts are long term and the company is profitable.

The "cash-flow test" requires an analysis of:

- The company's existing debts;
- Whether the company's debts are payable in the near future;
- The date each debt will be due for payment;
- The company's present and expected cash resources; and
- The dates any company income will be received.

The Court will consider whether the company is suffering from a temporary lack of liquidity (and therefore is not insolvent) or whether the company faces an "endemic shortage of working capital". In order to find that a company is insolvent a court will need to be convinced that the company has gone past the "point of no return" and is no longer viable to trade.

A court is also able to find that a company is presumed to be insolvent due to its failure to keep books and records as required by section 286 of the Act. In order for this presumption to be made, a liquidator needs to prove that either no records at all were kept or that the records that were kept are factually inaccurate and do not allow an accurate picture of the company's affairs to be made.[11] As any honest records the company holds will be enough to rebut the presumption of insolvency, Section 286 of the Act is rarely relied upon to prove insolvency.

8. What are the indicators of insolvency recognised by Courts?

When assessing whether a company or individual is insolvent and when that insolvency started, the courts refer to a number of factors.

[11] *Fisher v Devine Homes Pty Ltd; Allen v Harb* [2011] NSWSC 8.

In *ASIC v Plymin & Ors* (2003) 46 ASCR 126 (commonly referred to as the "Water Wheel case"), Justice Mandy of the Supreme Court of Victoria referred to a checklist of 14 indicators of insolvency:

(i) Continuing losses;

(ii) Liquidity ratio below 1 (a ratio of current assets to liabilities);

(iii) Overdue Commonwealth and State taxes;

(iv) Poor relationship with present bank including inability to borrow additional funds;

(v) No access to alternative finance;

(vi) Inability to raise further equity capital;

(vii) Supplier placing the debtor on COD (Cash on Delivery) terms, otherwise demanding special payments before resuming supply;

(viii) Creditors unpaid outside trading terms;

(ix) Issuing of post-dated cheques;

(x) Dishonoured cheques;

(xi) Special arrangements with selected creditors;

(xii) Solicitors' letter, summons(es), judgments or warrants issued against the company;

(xiii) Payments to creditors of rounded figures, which are irreconcilable to specific invoices;

(xiv) Inability to produce timely and accurate financial information to display the company's trading performance and financial position, and make reliable forecasts.

This is not an exhaustive list and it is not necessary for all of the above factors to be present for a company to be considered insolvent. It is possible for a company to remain solvent even when many of the above factors are present. This is particularly true where sufficient outside funds are available, such as funds from a director or other related party. It is possible for a company to prove solvency where they can show that an outside party could come to the company's aid. In this regard, it is important to note that the test for insolvency requires that a company is unable to pay debts. This inability to pay is not proven by the mere fact that debts were not paid. If the company could choose to ask for outside help, but did not, they may still be considered solvent.

9. What are the principal legal duties directors have?

The duties of company directors include both common law and statutory duties. These duties are set out below:

Common law (or fiduciary) duties

- *Duty to act in good faith*

  Directors have a duty to act in good faith in the interests of the company as a whole. The test as to whether this duty has been complied with is a subjective test of "honesty or good faith".

  Directors are in breach of this duty where they fail to give proper consideration to the company's interests. When considering the interests of the company, a director must take into account the interests of shareholders and creditors (in the case of an insolvent company).

- *Duty to exercise power for a proper purpose*

  Directors must not use their powers for an improper purpose. The test of whether a director has used their powers for an improper purpose is an objective test. Improper purposes may include when a director uses their power to gain an advantage for themselves[12], or by manipulating voting power.

  Regardless of whether the improper purpose is the dominant cause behind or one of a number of contributing causes to a director's decision, the act will be invalid if, but for the improper purpose, the decision would not have been made.[13]

- *Duty to retain discretion*

  Directors must not put themselves in a position where they are unable to act in the best interests of the company. For example, a director cannot contract with a third party to vote in a certain direction at board meetings.

- *Duty to avoid conflicts of interest*

  Directors must not put themselves in situations where their personal interests conflict with the interests of the company. If a director's duty to avoid conflicts is breached the director becomes liable to the company for any benefit derived, or to indemnify the company's loss. In addition, the company may void any contract that a director enters or has entered into as a result of the conflict of interest.

Statutory duties under the Act

- *Section 180(1) – Duty to act with care and diligence*

  Section 180 (1) reinforces the common law duty of the same name. Section 180(1) requires an objective standard of care, stipulating that a director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

  (a) were a director or officer of a corporation in the corporation's circumstances; and

[12] *Mills v Mills* (1938) 60 CLR 150 at 185.

[13] *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

(b) occupied the office held by, and had the same responsibilities within the corporation as a director or officer.[14]

Additionally, a director will be considered to have acted with the due care and diligence required when they have complied with the "business judgment rule" in making decisions relevant to the business of the company. The business judgment rule provides that a director must:

(a) make the judgment in good faith or for a proper purpose; and

(b) not have a material personal interest in the subject matter of the judgment; and

(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and

(d) rationally believe that the judgment is in the best interests of the corporation.[15]

- *Section 181(1) – Duty to act in good faith*

  This duty is consistent with the equivalent common law duty. Section 181(1) requires a director or other officer of a corporation to exercise their powers and discharge their duties:

  (a) in good faith in the best interests of the corporation; and

  (b) for a proper purpose.[16]

- *Section 182 – Duty not to make improper use of position*

  This section provides that a director must not improperly use their position to gain an advantage for themselves or someone else, or to cause a detriment to the corporation.[17]

  This duty is breached if a director has the intention and purpose of obtaining an advantage or causing a detriment, regardless of whether an actual benefit or detriment occurs in fact.[18]

- *Section 183 – Duty not to make improper use of information*

  This section provides that a person who obtains information because they are, or have been, a director of a corporation must not improperly use the information to:

  (a) gain an advantage for themselves or someone else; or

  (b) cause detriment to the corporation.[19]

  This duty continues after the person stops being an officer or employee of the corporation.

- *Section 588G – Duty not to trade whilst insolvent*

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[14] Section 180(1) *Corporations Act* 2001 (Cth).
[15] Section 180(2) *Corporations Act* 2001 (Cth).
[16] Section 181(1) *Corporations Act* 2001 (Cth).
[17] Section 182(1) *Corporations Act* 2001 (Cth).
[18] *R v Byrnes* (1995) 130 ALR 529.
[19] Section 183(1) *Corporations Act* 2001 (Cth).

This section provides that directors must ensure that the company does not incur a debt while insolvent. A person breaches this duty where:

(a) he or she is a director of the company when it incurs a debt;

(b) the company is insolvent at the time, or becomes insolvent by incurring the debt;

(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent by incurring the debt; and;

(d) he or she failed to prevent the company from incurring the debt.[20]

A director may also face criminal penalties for breaching this duty if his or her failure to prevent the debt was dishonest.[21]

- *Section 191 – Disclosure of material personal interests*

  This section provides that a director of a company who has a material personal interest in a matter that relates to the affairs of the company, must give the other directors notice of their interest.[22]

  There are various exceptions to this rule, including section 191(5), where companies with only one director are excluded.

- *Section 286 – Financial records*

  This section provides that a company must keep written financial records. This requirement relates to a director's duty of care and diligence and provides that directors may be subject to a penalty for failing to maintain proper financial records.

Directors who breach their duties may not only receive civil penalties, as in certain circumstances, but they may also be guilty of a criminal offence. For more information on penalties for breach of director's duties, see section 12 below.

10. What is insolvent trading?

Directors are under a duty to prevent insolvent trading under section 588G of the Act. A claim is under section 588G is only available to a liquidator after a company has been placed into liquidation.
For a liquidator to make a claim for insolvent trading against a director or former director, the following elements must be satisfied:

- the person was a director at the time that the debt was incurred;
- the company was insolvent at that time, or became insolvent by incurring the debt;
- at that time, there were reasonable grounds for suspecting insolvency, or that the company would become insolvent by incurring the debt; and
- at the time, the director was aware that there might be grounds for suspecting insolvency, or a reasonable person in a like position would be so aware.

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[20] Section 588G(1), (2) *Corporations Act* 2001 (Cth*).*
[21] Section 588G(3) *Corporations Act* 2001 (Cth*).*
[22] Section 191(1) *Corporations Act* 2001 (Cth*).*

If the director suspects that the company was insolvent at the time the debt was incurred and their failure to prevent the debt was dishonest they are also liable for criminal punishment.

Liquidators have a period of 6 years after their appointment to commence a claim against a Director for insolvent trading. After this date the commencement of a claim is statute barred.

If the liquidators choose not to pursue a claim for insolvent trading, the company's creditors (individually or in a group) may commence their own actions against the directors for insolvent trading, but this is limited to the debts owed to the creditors. Creditors may make a claim at any time if they have consent from the liquidator but they may only request the liquidator's consent after the liquidator has been appointed for 6 months.

The Federal Government have stated that they intend to legislate, as part of their innovation program, to create a safe harbour for directors from insolvent trading laws. If the proposals are legislated, directors will be able to avoid liability for insolvent trading by appointing a restructuring advisor to assist with the reorganisation of a company's affairs. This proposal is aimed at encouraging innovation, as it removes the threat from directors who want to/ intend to continue to trade. It should be noted however that while the insolvent trading penalties can be quite severe it is not a remedy that is frequently pursued by liquidators.

11. Why do directors need to watch out for Director Penalty Notices (DPNs) from the ATO?

A director of a company is under an obligation to ensure that their company remits all withheld Superannuation Guarantee Charge (*SGC*) and PAYG amounts to the Commissioner of Taxation (*the Commissioner*). A director can be held personally liable for a penalty equal to the amount of the company's unpaid PAYG and SGC debts, upon failing to ensure these debts are remitted when due.
To recover a penalty from a director, the Commissioner will issue a DPN and must wait until the 22nd day after issuing the notice before commencing proceedings (the timeframe for compliance with a DPN commences the date on which it is posted).

If a director is issued with a DPN there are limited options available to have the penalty remitted, however in order for the penalty to be remitted, action must be taken within 21 days of the notice being issued. For unpaid amounts that were reported in the company's Business Activity Statements (BAS) or Superannuation Guarantee Statements (SGS) within three months of their due date, the penalty will be discharged upon payment of the debt, or if an administrator is appointed under the Act or a liquidator is appointed to wind up the company. If the unpaid amount was not reported within three months of the due date, the debt must be repaid by the company to have the director's personal liability remitted.

This means that the directors of the company are personally responsible for the debt if the company leaves it unpaid.

If no action is taken before the 22nd day after the DPN is issued to the director, the penalty is not remitted and the director is held personally liable for the penalty amount until it is paid in full. To enforce this claim against the directors personally the ATO will then issue court proceedings for a liquidated claim in the amount of the outstanding debt.

New directors are not immune from the personal liabilities incurred by a DPN but a new director will not become liable for any existing PAYG or SCG debt until they have served as a director for 30 days. If the director remains a director of the company after the 30 day period has elapsed, they are then also personally liable for any outstanding PAYG and SGC debts. New directors however, will not be subject to the restricted remission options until 3 months after they become director of the company, regardless of how long the company has been liable for the debt.

12. What penalties can directors face for insolvent trading and breach of duty?

Directors can face a number of consequences for insolvent trading and breach of their duties. The penalties include civil penalties, compensation proceedings and criminal charges.
All company directors have a duty under section 588G of the Act to prevent insolvent trading. A director of a corporation must also exercise their powers and discharge their duties with a certain degree of care and diligence as stipulated by sections 180-184 of the Act.[23] A breach of either of these fundamental responsibilities by a director can lead to significant consequences for the directors personally, and the company as a whole.

Penalties include;

- On application for a civil penalty order, the court may order compensation; [24]
- If a court finds a person guilty of an offence under s588G(3) in relation to the incurring of a debt by a company whilst insolvent, the criminal court may order compensation;[25]
- A creditor may sue for compensation;[26] and
- A director may be held liable to indemnify the Commissioner of Taxation for unpaid debts.[27]

<u>Criminal penalties</u>

Section 184(1) of the Act provides that:

"(1) a director or other officer of a corporation commits an offence if they:

a) are reckless; or
b) are intentionally dishonest;

and fail to exercise their powers and discharge their duties:

c) in good faith and in the best interests of the corporation; or
d) for a proper purpose.

Schedule 3 of the Act provides that for a breach of section 184 above, directors may face fines of up to $360,000 or 5 years imprisonment, or both."

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[23] *Corporations Act 2001* (Cth).
[24] Ibid, s588J.
[25] Ibid s588K.
[26] Ibid, 588R and 588T.
[27] Ibid 588FGA.

Section 206B of the Act provides for the automatic disqualification of directors from managing corporations if they are convicted of a criminal offence related to the company.

Civil penalties

ASIC is responsible for the Australian securities regulation and has the power to apply for a declaration of contravention, a pecuniary penalty order and/or a compensation order under section 1317J of the Act. A creditor may also sue a company under the Act, for compensation. The Court may also order, on application by ASIC, to disqualify a director from managing corporations.[28]

Under division 4 of the Act, a director is liable to compensate the company for loss resulting from insolvent trading.[29] The director may face one of a number of consequences for any loss occurring to the company as a result of insolvent trading:

- The court may order the director to compensate the company for an amount equal to the loss or damage caused by the breach.[30]
- A creditor may recover from the director an amount equal to the loss or damage caused by the breach.[31]
- If the breach is proven to be as a result of the director's dishonesty, the director may be found guilty of a criminal offence, punishable by a fine or imprisonment.[32]

13. What immediate actions should directors of an SME take if their company is insolvent?

If a business is insolvent and it is unable to pay its debts when they fall due and payable, there are a number of risks that directors need to be prepared for. The first issue to consider is whether the insolvency is temporary, or whether there is an endemic shortage of working capital. If there is an endemic shortage of working capital the first steps should be:

- Consider whether to seek further working capital (debt or equity);
- Take steps to improve the quality of real time financial information for decision making; and
- Talk to your professional advisors to develop a game plan (exit or business continuity).

Seek more working capital

The first step may be to seek further working capital for the business, however in the long term this does not solve the problem if there is a loss making business model. Immediate options are:

[28] *Corporations Act 2001* (Cth) s206C.
[29] Ibid s588M.
[30] Ibid s588M and 588K.
[31] Ibid s588M.
[32] Ibid 588G(3) and Schedule 3.

- Receivables finance: Many businesses as a first step look at unlocking debtors by utilising receivables finance (also known as invoice discounting). This has the benefit of providing immediate access to funds waiting to be paid by debtors.
- Friends, fools and family: You can seek working capital (either debt or by granting equity) from those close to you. However, there is unlikely to be an alignment of interests and your lenders are unlikely to be able to assess the risk of lending to you. This may put pressure on your relationship in the event of non-payment and permanently damage relationships.
- Trade suppliers: You can contact your trade suppliers and ask them to extend terms. This will have the same effect as a bank overdraft extension on your financial position.

Obtain reliable financial information

Reliable financial information will help prevent a business from choosing the wrong strategy by giving the directors insight into why the business isn't achieving the required rate of return. There are three simple ways to ensure a business has reliable financial information:

1. Draw up an annual budget and cash flow forecast, as the year goes on compare the budget cash flow with actual figures;
2. Ensure you know what your product/service costs to produce and what affect it would have on profits if for example, sales were increased or decreased by 10%; and
3. Make sure your assets are valued correctly.

When a business is failing it can be tempting to get 'creative' with accounting and this is one symptom of impending business failure. Avoid the temptation to:

- Delay producing financial statements;
- Continue paying dividends (i.e. drawings) through incurring debt rather than retained earnings;
- Cut expenditure on routine maintenance;
- Start treating extraordinary income as ordinary income and vice versa;
- Change ownership title of main assets of the business;
- Value assets at inflated figures;
- Meet company debts out of your own pocket; and
- Value stock of finished products at the current market selling price rather than at cost.

What is your end game? Business continuity or business exit?

When a business hits rocky times the directors need to develop a clear business strategy. If the directors do not have a clear strategy they may get lost in the details of keeping the business afloat rather than driving towards their end game. If there is a profitable

core that is worth saving there is a choice between keeping the business and attempting to salvage it or selling the business.

A pre-pack insolvency arrangement is an alternative to appointing a voluntary administrator to salvage business value. The pre-pack insolvency arrangement gives the director the opportunity to consider a more orderly approach to a restructure before any formal appointment.

14. What types of professional advisors assist with a pre-pack insolvency arrangement?

The worst case scenario would be for a director of an insolvent SME to engage a group of different advisors without having one particular coordinating advisor. It is likely that a lawyer, small firm accountant and insolvency practitioner with different briefs would pull in opposite directions. Each professional would have a different methodology, timeframe, priorities and task list.
There are a number of different advisors who market themselves as being capable of providing advice, and helping with the setup of, and/or supervision of, pre-pack insolvency arrangements. These are:

Small Firm Accountants

Most directors will have an existing relationship with an accountant. These accountants are typically based at small suburban accounting practices with 2-3 partners or a sole practitioner.

Small firm accountants often provide advice regarding:

1. Business growth and working capital;
2. Estate planning and superannuation;
3. Business and personal taxation; and
4. Audit compliance.

Small firm accountants are usually members of either CPA Australia or the Chartered Accountants; however it is not a legal requirement for a practicing accountant to be a member of either professional body. While these professional bodies do have entry requirements, neither organisation requires its members to have deep insolvency knowledge. Small firm accountants are unlikely have thorough insolvency training and their knowledge is often obtained from attending creditors meetings, reading liquidation and administration reports, and talking to clients about their business failures. Deep knowledge of insolvency would require both a detailed understanding of the Act and policy regarding the insolvency regime and training in strategy from insolvency practitioners.

Accountants usually charge fees at an hourly rate broken down into 6 minute units. Small firm accountants are not usually paid per deliverable and their charging is opaque to an end client because the client has no understanding about the steps required to complete the task they engage their accountant to complete.

General accountants at small, non-specialist firms are unlikely to have extensive or up-to-date knowledge of insolvency law and practice. It is also unlikely that they work specifically, or regularly in the area of insolvency. While a small firm accountant can provide advice on certain aspects of a pre-pack insolvency arrangement, such as the taxation implications of transactions, they are unlikely to be ready to supervise or set-up a pre-pack arrangement as they generally do not have the specialist insolvency knowledge necessary.

Insolvency Practitioner

Insolvency practitioners are individuals registered with ASIC as liquidators. The peak body in Australia that represents insolvency practitioners is the Australian Restructuring, Insolvency and Turnaround Association (*ARITA*). Much like the accountants above, it is not essential that registered liquidators are members of this body. Insolvency practitioners are qualified to provide advice, and assist in the setup, or supervision of a pre-pack arrangement. Insolvency practitioners are likely to have a thorough and up-to-date understanding of insolvency law and practice, developed through education and day-to-day work on company liquidations and administrations.

Insolvency practitioners generally charge an hourly rate, broken down into 6 minute units. Different staff members working below them then charge at different rates based on experience in formal appointments. The limit on fees charged by insolvency practitioners is usually the value of the assets of the company in liquidation or administration, however there may also be creditor or director funding beyond this. In formal appointments the fees charged need to be approved by creditors, although failing this approval the insolvency practitioner can apply to the Court for approval. Insolvency practitioners will usually discuss options that directors have before taking an appointment as liquidator or voluntary administrator and often they do not charge for this advice because they generally expect to recover their fees once they are appointed.

Insolvency practitioners are subject to rules which limit their capacity to provide advice, help with the setup or supervision of a pre-pack arrangement. When they are approached, insolvency practitioners are required to turn down a formal appointment if they have a conflict of interest. The ARITA Code of Professional Practice for insolvency practitioners states that an insolvency practitioner must refuse an appointment where the practitioner has provided non-general advice to one of the directors of the insolvent company in respect of the director's duties to the insolvent company.[33] Insolvency practitioners are also required to refuse appointment where they have had a professional relationship with the insolvent company within the previous two years.[34] As a result of these conflict rules, insolvency practitioners are disqualified from advising and setting up and supervising a pre-pack arrangement if they intend to be later appointed as voluntary administrator or liquidator. The rationale for this limitation is that giving any kind of specific advice regarding a pre-pack arrangement may undermine an insolvency practitioner's impartiality.

There is also a larger issue to be considered by a company director. It is unlikely that an insolvency practitioner will receive a fraction of the fees that they could generate from a

[33] ARITA Code of Professional Practice for Insolvency Practitioners Rule 6.8.1(B).
[34] ARITA Code of Professional Practice for Insolvency Practitioners Rule 6.8.

voluntary administration. Therefore, insolvency practitioners are more likely to steer directors towards a voluntary administration than a less expensive pre-pack.

Lawyers

Specialist insolvency lawyers can advise regarding the legality of a pre-pack arrangement and supervise the setup of a pre-pack arrangement. Lawyers who specialise in the field will have an up-to-date knowledge of insolvency law, however lawyers are not usually experienced in all aspects of a pre-pack insolvency arrangement. Whilst they are qualified to supervise the pre-pack process and provide advice on its legality, most lawyers are not experienced in the financial and practical aspects of setting up of a pre-pack insolvency arrangement. This is principally because lawyers generally only provide "legal services".

Specialist insolvency lawyers are generally more expensive, charging rates of around $400-$600 per hour, broken down into 6 minute units. Legal services are defined in section 6 of the *Legal Profession Uniform Law* as "work done, or business transacted, in the ordinary course of legal practice".[35] Most tasks in the preparation of a pre-pack arrangement relate to consulting and business strategy and therefore are not strictly "legal services". Most lawyers will choose not to undertake these tasks, and are likely to want to restrict their involvement to providing services that are within the scope of legal services (i.e. advising on the transactions involved in the pre-pack arrangement and drafting documents). Relying on lawyers to co-ordinate may put the directors at risk, by having a number of professional advisors pulling in different directions as a result of not sharing the same brief.

On the other hand it may be useful to have a lawyer draft a business sale or asset sale contract rather than prepare one yourself. This may put you at risk of the transaction being unwound by a liquidator.

Pre-insolvency Advisors

There are a number of consultants that hold themselves out to be pre-insolvency advisors. They do not offer legal or accounting services and are not qualified insolvency practitioners. Pre-insolvency advisors are often led by a charismatic individual who will have experience in some field of business without necessarily having extensive experience in insolvency. Pre-insolvency advisors are also often employed by financiers and insolvency practitioners for lead generation (i.e. business development on a commission-business).

Their charging structures vary depending on the particular advisor, but there is often a sign-up fee involved as well as a fee based on a percentage of turnover of the company.

Pre-insolvency advisors are not registered with ASIC. They do not have an overarching body with a code of conduct to which they need to comply, or any necessary level of experience or training benchmarks. This is in contrast to both lawyers and insolvency practitioners who have professional bodies to whom they are answerable to. The key takeaway is that these advisors frequently have inadequate knowledge and experience of insolvency. Due to their

[35] *Legal Profession Uniform Law (NSW)* Section 6.

inadequate training and lack of insolvency experience, pre-insolvency advisors often have no explainable methodology for company restructuring.

However, if a pre-insolvency advisor has industry-specific knowledge built up from experience this may be useful. They are unlikely, however, to have the legal skill to develop the terms and documentation for the pre-pack.

15. What are the duties of professional advisors advising insolvent SMEs?

Advisors are obliged to comply with the Act. In particular, section 79 of the Act provides that an advisor is involved in a contravention of the Act if the person: has aided, abetted, counselled or procured the contravention; or has induced, whether by threats or promises or otherwise, the contravention; or has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or has conspired with others to effect the contravention.
This means that professional advisors have accessorial liability for breaches of director's duties by their clients where they have aided the client to breach their duties.

The ARITA also has a Code of Professional Practice, which has become an established part of the insolvency industry in Australia. Although it is not legally binding, courts have referred to the importance of insolvency practitioners adhering with the code.

<u>The Somerville case</u>

In the case of *ASIC v Somerville & Ors* [2009] NSWSC 934, the Supreme Court of New South Wales found Mr Somerville, a solicitor, guilty of aiding and abetting directors to breach their duties by devising an "asset stripping" scheme.

Mr Somerville advised a number of directors of companies in financial difficulty. His advice was to restructure each of the companies, as follows:

- The old company ceased to trade;
- A new company was established;
- The old company sold its assets to the new company on the following terms:
    - Assets transferred from old company to new company;
    - New company issued "V" class shares to the old company as consideration for the purchase of assets;
    - Employees of the old company were terminated and offered employment with the new company;
    - New company took over plant, equipment and leases through the asset sale;
    - Debts and liabilities remained with the old company.

The Court found the transactions were for inadequate consideration, no dividend was intended to be paid by the "V" class shares.

The Court found that Mr Somerville had breached section 79 of the Act as the transaction had no commercial basis and was considered asset stripping.

LIQUIDATORS OF SMES

16. What are liquidators and what do they do?

A liquidator is a person who is registered with ASIC as a liquidator and who is authorised to be a liquidator and voluntary administrator of a company. Registered liquidators act in a fiduciary capacity and have total management control of the affairs of a company once appointed as liquidator. The role of the liquidator in an insolvent liquidation is to collect and deal with the company's assets and where available, distribute the recoveries to the unpaid creditors of the company in liquidation. There are generally two categories of liquidators:

i. Registered liquidators (registered with ASIC) who can accept non-insolvency appointments; and
ii. Official liquidators who can accept all types of appointments, including court ordered appointments and voluntary administrations.

When a company is in liquidation due to its insolvency, the liquidator has a duty to all of the company's creditors. The liquidator will investigate the financial affairs of the company and it is a primary role of the liquidator to establish when and what caused the company to become insolvent. Establishing the date of insolvency is an important part of the liquidator's job, because the date of insolvency will help to determine whether any transactions can be clawed back for the benefit of creditors.

A liquidator has the following functions:

- To collect and take control of the company's assets;
- Review the company's pre-liquidation transactions to ascertain whether any may be voidable as uncommercial transactions[36] or unfair preferences;[37]
- Conduct investigations as to whether they may be any causes of action against directors for insolvent trading or other breach of duty;
- Make recoveries;
- Report findings to the creditors and ASIC;
- Evaluate claims against the company by creditors (proofs of debt);
- Distribute funds available towards the payment of the liquidators costs, and creditors' claims, with regard to the prescribed priorities for payment including employee entitlements; and
- Apply for deregistration of the company at the finalisation of the liquidation process.

The duties of liquidators, once appointed, are principally focused on complying with the Act and, more specifically, acting in the interests of creditors. Any undertaking given by liquidators before their appointment is unenforceable at law.

[36] *Corporations Act 2001* (Cth) s588FB.
[37] Ibid, s588FA.

17. What is the downside of a liquidation fire sale?

A fire sale is likely to result in a sale price (and process) that is suboptimal. It may be suboptimal because the price is based upon a breakup value of assets through a rushed sale process where the purchasers have an expectation of a heavy discount.
The principal issues with a forced sale of business assets in a liquidation scenario are that:

- Going concern value may be lost if the business ceases trading;
- It is unlikely to deliver an optimal price;
- There is insufficient motivation to maximise the sale price on the part of the liquidator;
- There is no control over who purchases the business;
- Third party purchasers may take advantage of timing limitations; and
- There is no guarantee the business will even be sold.

The going concern value may be lost if the business ceases trading

A liquidator is under no obligation to continue trading after appointment; it is therefore rare that they would continue to trade a business as they may become liable for incurred debts. On the other hand a voluntary administrator or receiver has scope in their appointment to continue to trade the business with a view to selling the assets as a going concern.

If a business ceases to trade it is unlikely that a seller will be able to persuade a purchaser to value the business using a multiple of maintainable earning methodology. The result would be that the purchase price is determined by the break-up value of the assets and that there would be no value attributed to the goodwill of the business.

Under Australian law liquidators are limited in their ability to trade a business, and the scope extends only so far as it is necessary for its beneficial disposal.[38] Liquidators would be likely to seek the approval of a committee of creditors before taking a risk and on trading a business.

Unlikely to deliver an optimal price

The downside of liquidation is that the liquidator is not under any obligation to manage the sale process with a view to obtaining an optimal price for the assets. A forced sale for asset value alone may mean that a third party purchaser obtains a price below the economic value of the business.

On the other hand, if the existing proprietors are the only interested party in the purchase of the business they may be able to repurchase the business from a liquidator below its economic value.

The liquidator's legal obligation is to deal with assets only so far as is necessary for the beneficial winding up of the company.

[38] Section 477(1)(a) Corporations Act

Lack of motivation to optimise sale price on the part of the liquidator

Without exploring a theory of motivation for economic players it may be sufficient to point out that a liquidator has no “skin in the game” in the sale process.

A liquidator is renumerated on a fixed fee or hourly basis. Therefore liquidators have a positive motivation to avoid a complicated or protracted sale process because it won’t improve their fee income significantly. Most of a liquidator’s fees will be generated by having junior staff conduct due diligence, deal with various stakeholders and otherwise “tick boxes”.

This may be described as an agency problem. The Australian insolvency system (unlike the United States and Chapter 11) is designed to ensure that an impartial independent insolvency practitioner is appointed.

The liquidator’s first priority is usually to receive money into the liquidation to pay their costs and disbursements and comply with their statutory responsibilities overall. There is no bonus structure in place to reward a liquidator who achieves a superior outcome in any sale process. The nature of hourly fees has been criticised as encouraging unethical and inefficient practices in business because it is not aligned with the deliverable to maximise economic value.

Lack of control over who purchases the business

The liquidator has the following options in a business sale process:

1. Private contract;
2. Public auction;
3. Tender; or
4. Clearance sale.

It is illegal for a liquidator to enter into a binding arrangement regarding a sale before their appointment (with the directors) and therefore it is a risk that directors of insolvent businesses may not be able to repurchase the business after liquidation.

There are no “black letter” rules that require a liquidator to implement any particular sale process and it comes down to individual judgment. The Courts have historically been reluctant to interfere in a liquidation sale process unless there is clear evidence of prejudice to the interests of creditors.

If directors are looking to execute a pre-pack arrangement it would reduce their risk to execute the transaction before the appointment of a liquidator. After appointment the liquidator is obliged to consider the best interests of creditors and therefore the economic interests of owners may be ignored.

Third party purchasers may take advantage of timing limitations

Purchasers involved in a liquidation sale process (frequently advertised as a Mortgagee-in-possession sale) will understand that the seller (i.e. the liquidator) is focused

on selling without much delay. This doesn't give the liquidator room to adjust their strategy and if the sale process has few purchasers there is unlikely to be any "bid tension".

There is no guarantee that the business will even be sold. The liquidator is not penalised if the sales process falls through, and it frequently does. If a sales process fails a liquidator may transfer any plant and equipment and other goods to an auction for a scheduled auction sale.

18. When can a liquidator claw back transactions made to related entities including a new company?

A related entity is defined with an exhaustive list of persons who are related in some way to the directors or shareholders.[39] This includes relatives, spouses, trusts, and companies owned by the director, shareholders or their relatives.
A liquidator can claw back transactions before liquidation on the basis that the transaction was an insolvent transaction. The policy is that if a transaction was entered into whilst a company was insolvent it should be examined by a liquidator.

Liquidators have powers under the Act to claw back assets and payment transfers that occurred in the time period immediately before the company went into liquidation.

Voidable insolvent transactions include the following:

- Unfair preference payments
  Under section 588FA of the Act, a transaction may be considered an unfair preference payment to a creditor if:

  a) the company and the creditor are parties to the transaction (even if someone else is also a party); and

  b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company.

- Uncommercial transactions
  Under section 588FB of the Act, a transaction of a company is considered an uncommercial transaction if it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to:

  a) the benefits (if any) to the company of entering into the transaction;

  b) the detriment to the company of entering into the transaction;

  c) the respective benefits to the other parties to the transaction; and

[39] Corporations Act 2001 (Cth) Section 9.

d) any other relevant matter.

- Unreasonable director-related transactions
  Under section 588FDA of the Act, a transaction is considered an unreasonable director-related transaction if:

  a) the transaction is:

    i) a payment made by the company; or

    ii) a conveyance, transfer or other disposition by the company of property of the company; or

    iii) the issue of securities by the company; or

    iv) the incurring by the company of an obligation to make such a payment, disposition or issue; and

  b) they payment, disposition or issue is, or is to be, made to:

    i) a director of the company; or

    ii) a close associate of a director of the company; or

    iii) a person on behalf of, or for the benefit of, a person mentioned in subparagraph (i) or (ii); and

  c) it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to:

    i) the benefits (if any) to the company of entering into the transaction; and

    ii) the detriment to the company of entering into the transaction; and

    iii) the respective benefits to other parties to the transaction, of entering into it; and

    iv) any other relevant matter.

In addition, a liquidator may commence a claim against a related entity for a benefit resulting from an insolvent transaction under section 588FH of the Act, where the transaction has the effect of discharging, to the extent of a particular amount, a liability (whether under a guarantee or otherwise and whether contingent or otherwise) of a related entity of the company.

VOLUNTARY ADMINISTRATORS OF SMES

19. Why do SMEs appoint voluntary administrators?

The voluntary administration regime was intended to create a statutory mechanism to turnaround an insolvent business under the supervision of an insolvency practitioner. It is the

principal legal mechanism for dealing with insolvency and giving insolvent SMEs breathing space to persuade creditors to accept a compromise.
However, judging the success of the voluntary administration regime is problematic because:

1. There is very little empirical research into voluntary administration; and
2. The research that is available does not support the proposition that voluntary administration succeeds in the majority of cases.

It is a reasonable hypothesis that when directors appoint voluntary administrators they may be unwittingly opening a "pandora's box" without considering the risk.

A 1998 Australian Securities Commission (*ASC*) research paper reported the outcomes of empirical research into the reasons that directors appointed a voluntary administrator.[40] The study found that of 55 voluntary administrations the motivation behind the appointment of an administrator included:

- To restructure (33%), as there was a problem with the financial, management or legal structure of business that could be altered by voluntary administration.
- To avoid consequences of liquidation (20%). However, this may have been to avoid the consequences of an insolvent trading claim or the recovery of a voidable transaction.
- To facilitate a liquidation (20%). This may be part of a strategy to delay liquidation and, for example, may be to facilitate an asset sale while the business trades under administration (i.e. a pre-pack arrangement).
- To avoid directors' liability for withholding company tax (7%). This is likely to have altered with the introduction of director penalty notices and automatic liability for specific taxation liabilities. It is likely to be a more important consideration today.

Academic writer, Eow (2006) considered the question of whether voluntary administration was an enabler of strategic behaviour or abuse, and identified 6 principal motivations of business owners and directors when commencing the voluntary administration process.[41] Eow analysed the motivations behind the appointment of a voluntary administrator and found that the motivations were contrary to the intentions of policy makers.

The 6 principal motivations were:

- Delay creditors: Using the process to delay creditor action;
- Litigation tactic: Staying winding up applications or other causes of action being litigated;

[40] ASC Research Paper 98/01, *A study of voluntary administrations in NSW,* Australian Securities Commission, Sydney, 1998 at pp26-27

[41] Eow, I., 'The door to reorganisation: Strategic behaviour or abuse of voluntary administration?' *Melbourne University Law Review* 11 (2003) 30 2

- Director's escape valve: Avoiding investigations that may follow a liquidation;
- Control of the company: Resolution of internal disputes between directors/ business owners;
- Employees: Stifling enterprise bargaining/employment disputes;
- Future complaints: Avoid compensating future claimants by staying contingent claims;
- Relation-back period deferred: Deferring the start of relation back period if a winding up application is filed.

The above is a list of the challenges that the voluntary administration regime may tactically deliver. From an insolvency lawyer's point of view there is a critical difference between motivations that are against policy and motivations that are illegal. There is no suggestion that the above motivations are illegal, and accordingly these tactics are being utilised by pre-insolvency advisors regularly. There may however be good practical reasons to avoid a voluntary administration, it may fail to deliver a debt free business with harmonious employee and supplier relationships after it has completed.

20. What is the downside of voluntary administration?

There are numerous downsides to the voluntary administration regime for directors of SME's. These include costs, publicity, loss of control, termination of supplier and customer relationships and the "Black Swan" event.
Costs of Voluntary Administration

When a voluntary administrator is appointed to a company they are entitled to recover their fees from the company in administration. Ultimately, these fees need to be approved by the creditors or by the court and this is outside of the control of the directors. While the exact cost of a voluntary administration will vary depending on the circumstances of the company in administration, there are a number of tasks which an administrator is required by the Act to carry out.

These include:

a) Notifying ASIC of the administration (r 5.3A.03 *Corporations Regulations 2001*);
b) Issuing notices to creditors (s439A);
c) Conducting the first meeting of creditors (s436E);
d) Dealing with creditor's enquiries (s437A);
e) Investigating the affairs of the company and forming an opinion on the best course of action for the company (S438A);
f) Preliminary Investigations into whether there are any transactions that would be voidable transactions in a liquidation (r5.3A.02 *Corporations Regulations 2001);*
g) Reporting any suspected misconduct by directors to ASIC (S438D);
h) Preparing and issuing a detailed report to creditors (S439A);
i) Conducting the second meeting of creditors (S439A, S439B); and
j) Notifying ASIC of the outcome of the second meeting of creditors (r 5.3A.01 *Corporations Regulations 2001*).

In a typical voluntary administration an administrator may also need to carry out tasks not specifically prescribed by statute, such as:

a) Trading the business;
b) Dealing with secured creditors;
c) Dealing with finance customers and suppliers;
d) Dealing with employees
e) Collecting and selling assets of the company;
f) Detailed investigations into potential recoveries and asset ownership.

The costs of the administrator are charged at an hourly rate, broken down into 6 minute units. These fees are approved by creditors at the first and second meeting of creditors. If the company decides to enter into a deed of company arrangement, the company will remain under the supervision of a deed administrator (normally the voluntary administrator) and further costs will be incurred, with no guarantee the business will survive. ASIC has reported that of the 5760 companies that entered into voluntary administration between 1993 and 1997, only 10% resumed normal trading at the conclusion of the process.[42]

There is very little empirical research on the success rates of voluntary administration that can contradict this 10% finding.

The costs of a voluntary administration for a SME are likely compared to the engagement of other professionals such as bookkeepers, IT consultants, engineers etc. The economic reason for high pricing is the personal trading risk administrators assume (they pay for any shortfalls in trading receipts) and that some appointments taken do not sufficiently pay the appointers fees. To compensate for this the appointers charge heavily when they have a job that is fully funded. There is also (largely anecdotal evidence) a view that insolvency practitioners are too numerous, or alternatively that there are too few jobs to support them.

Public Process

Within three days of taking an appointment, administrators are required to publish a notice of their appointment as administrator of the company.[43] This means that all creditors, as well as the public, will become aware that the business is insolvent and this will reduce the chance that the business may be able to continue to viably trade.

The consequences of all the suppliers, customers and employees being on notice that the company is insolvent are difficult to predict. In the Geon Group liquidation (a commercial printer business) the paper suppliers combined to refuse to supply any stock to the administrators and they were forced to close the business.

Loss of Control

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[42] *Parliamentary Joint Committee on Corporations and Financial Services, Corporate Insolvency Laws: a stocktake June 2004, Chapter 5 at [5.12]*

[43] Corporations Act 2001 (Cth) Section 450A.

Sections 437A and 437C of the Act require that upon the appointment of the administrator, control of the company passes from the directors to the administrator, once this has occurred the directors must not act without the consent of the administrator. This means that the control of the company is taken over by an accountant who specialises in insolvency rather than a person with knowledge of the business and its markets. There is no guarantee that the administrator will have knowledge of the industry in which the company operates or have the management skills necessary to ensure the survival of the business. In the alternative, it is likely that they do not.

There are often undertakings or understandings regarding how an administrator will conduct business. Any such undertakings are unenforceable by law and further there is no guarantee that the business will continue to trade and not be closed. This is a judgment call of the administrator.

The process of voluntary administration involves two meetings of creditors, required by sections 436E and 439A of the Act. At the second meeting of creditors the creditors vote on whether to go ahead with the reorganisation of the company proposed by the directors. The ultimate question as to whether or not the business can trade on or be sold as a going concern is thus in the hands of the company's creditors, but the voluntary administrator has the reins of the company from the date of their appointment.

It is within the power of the administrator to sell the business assets before the second meeting of creditors, but they usually do not want to do this because it may expose them to criticism from creditors. It is unlikely, due to time constraints, that the administrator will be able to offer the business assets for public sale, complete their report and prepare a comprehensive report to creditors before convening the second meeting. To avoid this the administrator often licences business assets to directors upon appointment.

Ipso Facto Clauses

Properly drafted commercial contracts often include a provision called an *ipso facto* clause. An *ipso facto* clause provides that upon an 'insolvency event' occurring, the solvent party has the right to terminate the contract. A company entering into voluntary administration falls within the definition of an 'insolvency event'.

When a company enters into voluntary administration, their suppliers, customers, landlords and financiers frequently make use of the *ipso facto* clause to terminate their contracts and call in their debt irrespective of payment terms. A flight of suppliers and customers may force the company to cease trading, meaning that any proposal for a compromise becomes academic because it is impractical to continue trading.

This means that voluntary administrations over retail premises, franchisers and distributors are not usually recommended.

The Government is currently proposing to introduce legislation which would make *ipso facto* clauses unenforceable if a company is undertaking a restructure. This will mean that if a company is undertaking a restructure under an administration, then an *ipso facto* clause will become temporarily unenforceable during voluntary administration.

Black Swan Event

A Black Swan event, in finance, is an event or occurrence that deviates from what is normally expected and it is extremely difficult to forecast. The appointment of a voluntary administrator opens a ‘pandora’s box’. A business is taken over by a qualified advisor, suppliers and customers are then informed of the company’s insolvency and invited to vote and decide upon the future of the company, at this stage employees are given a strong signal that the future prospects of the company are limited. In this scenario of conflicting interests unpredictable outcomes are foreseeable but not easily foreseeable at the start of the process.

21. Why is a voluntary administration impractical for a microbusiness?

The key issues with appointing a voluntary administrator over a microbusiness (being a business with 1-4 employees) are:

- It may be overkill because debt issues could possibly be resolved informally;
- Many businesses in this category trade as sole traders or partnerships and voluntary administration does not apply to unincorporated businesses;
- The costs may outweigh any economic benefit; and
- There may be other tactics such as a transfer to related parties that may be a more efficient tactic.

Overkill

The voluntary administration process involves two meetings of creditors, investigations by an insolvency practitioner and the involvement a variety of other professionals including valuers, auctioneers, lawyers and IT advisors.

If there are a small number of creditors and there appears to be a straight-forward root cause for the insolvency challenge the involvement of all the stakeholders and professionals may become counterproductive. Simple and straightforward negotiations with creditors, suppliers and staff may be sufficient to negotiate a compromised solution for microbusinesses to avoid a formal appointment.

Unincorporated businesses

Many microbusinesses trade as sole traders or in partnerships and therefore a voluntary administration is not applicable because it applies only to companies.

Further, there is only a temporary protection in voluntary administration to stop the enforcement of personal guarantees and therefore even if a compromise is entered into (i.e. a deed of company arrangement) this will not stop creditors from enforcing personal guarantees after the voluntary administration process is completed. This is important for small businesses because suppliers and financiers often request personal guarantees from directors and therefore the deliverable of a deed of company arrangement may be hollow if the directors are called on to pay the shortfall once the deed has been effectuated.

Costs too high

There is very little empirical research into the professional costs of voluntary administration, however, it would be accurate to point out that the costs are increasing. Since voluntary administration commenced in 1993 the complexity of the process has increased and the input costs of the professional firms (i.e. staff, IT, disbursements, lawyers etc.) has also dramatically increased.

It would be surprising if an insolvency practitioner was prepared to take an appointment for less than $40,000 making this a costly expedition for a microbusiness. If a practitioner were to take on the appointment for less than this amount they would be at liberty to apply for further costs to be approved from creditors and therefore any pre-appointment undertaking is reversible.

Other tactics may be more efficient

If a micro-business has no intellectual property, and only a handful of contracts and personal relationships with customers that drive business and revenues based upon the skills of the proprietors, there may not be any commercial or legal reason to spend the funds to appoint a voluntary administrator to protect the trading entity (i.e. the corporate shell).

It may be in the interests of the directors to consider whether to appoint a liquidator and continue trading through another business entity. The methodology of a pre-pack insolvency arrangement may be a suitable instrument but legal and accounting advice should be sought before considering it as an alternative to voluntarily administration for business rescue.

22. Are insolvency practitioners under a conflict of interest when advising on a pre-pack voluntary administration?

A conflict of interest arises when the interest of the insolvency practitioner diverts from their client. When providing professional advice consultants take a fiduciary duty at law to not prefer their interests to their client's interests.
Insolvency practitioners can also put themselves into a position of conflict where they take on an insolvency appointment and they have a statutory obligation to investigate the product of their own advice (i.e. a pre-pack insolvency arrangement).

The risk in taking advice from an insolvency practitioner is that if they are subsequently appointed as voluntary administrator they will be in breach of their professional obligations. The ARITA professional code requires insolvency practitioners to refuse an appointment where they have had a significant professional relationship in the previous two years.[44]

It is unlikely that an insolvency practitioner would prefer to provide ad hoc advice than take an appointment as voluntary administrator because of the substantial professional fees that they would earn through a voluntary administration.

It is recommended that any advice is subject to strict confidentiality and that in the event there are problematic transactions that a lawyer be engaged to ensure legal professional privilege applies.

[44] ARITA Code of Professional Practice Rule 6.8.1(B).

RESTRUCTURING OF SMES

23. What does the law consider to be phoenix activity?

There is no legal definition of phoenix activity (also known as phoenix arrangements) in the Act or in any other legislation.[45]
The Department of Treasury defines phoenix activity as:

> *"The evasion of tax through the deliberate, systematic and sometimes cyclic liquidation of related corporate trading entities."*[46]

While it is not specifically defined in statute, the sale of a business will constitute phoenix activity when:

- Oldco is insolvent;
- Oldco's business is transferred for inadequate payment to Newco;
- This transaction is detrimental to creditors, employees and other stakeholders; and (often)
- There is a cyclical element because it is repeated.

The term "phoenix activity" has a long history. The "Bottom of the Harbour" schemes attracted attention from the ATO in the 1970s and 1980s. These schemes were promoted by lawyers and accountants to help entrepreneurs strip assets and profits from companies, leaving the ATO and other creditors stranded without any recourse in pursuit of debts.

The "Bottom of the Harbour" schemes led the Federal Government to introduce the *Crimes (Taxation Offences) Act 1980* (Cth). This statute makes it a criminal offence to enter into an arrangement with the intention of creating an arrangement to cause a company to be unable to pay taxes, such as income tax and the superannuation guarantee charge.[47] The statute also extends criminal liability to advisors who assist others in entering into such arrangements.[48] The penalty can be up to ten years in jail and a fine of up to $180,000.[49] The court can also order that an individual be liable to pay the outstanding tax liabilities. While we have found no recent case law where anyone has been charged under this statute, it is important for directors and their advisors to be aware of it. It is possible that the failure to prosecute under this statute stems from the difficulty to prove beyond a reasonable doubt that there was an intention to avoid payment of taxes and debts.[50]

Phoenix activity is also known as asset stripping because it involves expropriating all useful assets from a company for a low price or as part of a sham transaction. Research carried

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[45] Phoenix activity is not defined by the *Corporations Act 2001.*
[46] Australian Government, Action Against Fraudulent Phoenix Activity November 2009, Phoenix Proposal Paper, www.archive.treasury.gov.au/documents/1647/PDF/Phoenix_Proposal_Paper.pdf.
[47] *Crimes (Taxation Offences) Act 1980 s5.*
[48] *Crimes (Taxation Offences) Act 1980 s6.*
[49] *Crimes (Taxation Offences) Act 1980.*
[50] Helen Anderson, "The Proposed Deterrence of Phoenix Activity: An Opportunity Lost", (2012) 34(3) *Sydney Law Review* 411 p417.

out by the ASC in 1996 found that 18% of SMEs had been adversely exposed to phoenix company activity.[51] For most companies this would be as a result of being an unpaid creditor to a company which undertook phoenix activity.

Phoenix activity occurs for a broad range of reasons:

- Directors might be pocketing funds to pay for a lifestyle that drains the business;
- Businesses having unsustainable business models;
- In a dishonest attempt to evade a company's debts; or
- It may be an attempt at disaster recovery.

Liquidators have the power under the Act to apply to the court to claw back assets or value in certain transactions.[52] Liquidators are under no obligation however to take this action if they have no funds to pay for legal action.

The phoenix operator's model in the past has been to appoint their preferred liquidator after the assets of a business are transferred out of the company, leaving an empty shell. The liquidator is paid a fee that would cover basic work but nothing beyond this and so the liquidator is forced to seek funds from the creditors. The phoenix operators are confident that creditors will not fund the liquidator (i.e. and "throw good money after bad") and therefore the asset transfers will not be challenged. There is also an understanding that if a liquidator were to pursue the phoenix activity vigorously they may prejudice themselves for future appointments.

Part 5.4C of the Act was introduced in 2011 and its stated aim is to eradicate phoenix activity. Part 5.4C of the Act gives ASIC the power to appoint a liquidator to a company which it believes to be abandoned. This means, that where a business has been phoenixed, and no creditors have taken action to appoint a liquidator, ASIC can appoint a liquidator without needing to apply to the court. The purpose of the liquidator is to then uncover breaches of the law occurring as a result of the phoenix activity and take legal action.[53] However, if the liquidator is appointed to an asset less administration they will undertake a cost/benefit assessment before taking action. If the costs/benefit analysis (i.e. the recoverability of fees) is unfavourable they will be unlikely to proceed with action. Further, there is no empirical evidence to suggest that ASIC has used this power to wind up SMEs at all.

A report from Melbourne Law School called 'Defining and Profiling Phoenix Activity"[54] outlines a history of definitions of phoenix activity. The report demonstrates that the definition of phoenix activity is amorphous and that there is no accepted definition at law. The report concludes that there is a difference between certain types of phoenix activity. The report differentiates the types of phoenix activity that are illegal, and types that may be considered

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[51] Australian Securities Commission 1996, Research Paper No 95/01-*Phoenix Companies and Insolvent Trading*, Canberra.
[52] Discussed at Chapter 24.
[53] Helen Anderson, "The Proposed Deterrence of Phoenix Activity: An Opportunity Lost", (2012) 34(3) *Sydney Law Review* 411 p424.
[54] Helen Anderson, Ann O'Connell, Ian Ramsay, Michelle Welsh, Hannah Withers "*Defining and Profiling Phoenix Activity*", December 2014.

legal, and discusses the relevance of a determination based on the intention behind the activity. The report states:

> "*The behaviour becomes illegal where the intention of the company's controllers is to use the company's failure as a device to avoid paying Oldco's creditors that which they otherwise would have received had the company's assets been properly dealt with.*"[55]

The report separates phoenix activity into five categories, categorising them into activities that should be considered legal phoenix activity, or business rescues, and those that should be categorised as illegal phoenix activity.

The categories of phoenix activities identified by the report are:

- Legal phoenix or business rescue

  The best example of this is a business owner whose business was damaged by a flood. An unpredictable event that devastated the business but the underlying business is viable and the owner wants to continue to use the business name, goodwill, client list, intellectual property, etc. In this scenario a transfer is legal if it does not fall foul of the laws relating to uncommercial transactions and breach of directors duties. For a transaction to be considered a legal phoenix any transfer must be for adequate consideration.

  The academics emphasise that in this scenario there is no intention to avoid paying creditors and it is beneficial economically because a viable business can be rescued.

- The problematic phoenix

  An example of this is a person with poor business skills continuing an uneconomic business. This type of phoenix activity is argued to be technically legal because there is no intention to defraud creditors. It is also legal because it involves a transfer for adequate consideration so it does not contravene the Act. In the writer's opinion, this scenario is problematic because the resurrection is not beneficial to the economy.

- Illegal phoenix 1: Intention to avoid debts formed as the company begins to fail

  There is an intention to defraud creditors, which involves the transfer of assets for a below value price. This intention is usually formed after the business becomes insolvent.

- Illegal phoenix 2: Phoenix as a business model

  This scenario is where a company is deliberately set up to be phoenixed. From the inception of the company its primary intention was to be phoenixed. In the building and construction industry there have been labour hire subsidiaries that are liquidated to avoid tax and employee entitlements that fit within this category. This leads to

[55] Helen Anderson, Ann O'Connell, Ian Ramsay, Michelle Welsh, Hannah Withers "*Defining and Profiling Phoenix Activity*", December 2014 p1.

economic consequences, because it gives the phoenix operators an unfair competitive advantage, while forcing employees to be reliant on the government for payment of entitlements.

- Complex illegal phoenix activity

  This final category involves a phoenix intention at the inception of the company (i.e. illegal phoenix 2) but with added illegality. One example cited by the report is a case where the directors used false ABNs to confuse the ATO and combined this with cyclical phoenix of tax burdened companies.

24. When can an insolvent business be transferred to a related entity?

There is no specific section of the Act or of any other legislation that prohibits the transfer of an insolvent business to a related entity. There are however, some powers a liquidator has to overturn a sale to a related entity.
If a court finds that the sale amounted to either an uncommercial transaction or an unreasonable director-related transaction the liquidator can have it overturned or have Newco or the directors compensate Oldco for the loss suffered.[56]

An uncommercial transaction is defined as a transaction where it "may be expected that a reasonable person in in the company's circumstances would not have entered into, having regard to:

a) The benefits (if any) to the company on entering into the transaction;

b) The detriment to the company of entering into the transaction;

c) The respective benefits to other parties to the transactions of entering into it; and

d) Any other relevant matter."[57]

A liquidator has the power to apply to a court to claw back an uncommercial transaction that is also an insolvent transaction that was entered into in the 2 years preceding their appointment as liquidator.

An unreasonable director-related transaction is defined as a transfer of business assets to a director where "it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction".[58]

A liquidator may apply to a court to overturn an unreasonable director-related transaction if it was entered into in the 4 years prior to the appointment of the liquidator.[59] Unlike with uncommercial transactions, the liquidator does not need to prove that Oldco was insolvent at the time of the director-related transaction.

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[56] *Corporations Act 2001* s588FF.
[57] *Corporations Act 2001* s588FB.
[58] Corporations Act 2001 s588FDA.
[59] Corporations Act 2001 s 588FE.

In order to avoid claw back action from a liquidator the directors need to ensure that any sale of an insolvent business from Oldco to a related entity is for a reasonable price or for adequate consideration.

The Government is currently proposing, as part of its Innovation Reforms, to introduce a safe harbour defence for directors in situations where the director has appointed a pre-insolvency advisor. The safe harbour would protect the director from liability for insolvent trading while the company attempts to restructure.[60] This restructuring could include the sale of the business to a new related entity on commercial terms.

At present, if the sale of the business occurred before the appointment of an administrator or liquidator, the directors could be liable to a subsequently appointed liquidator for insolvent trading.

Due to the issues outlined above it is preferable for any sale of an insolvent business to occur after the appointment of an administrator of liquidator, or to at least be subject to the approval of a later appointed liquidator or administrator. It is also imperative for the directors of the business to ensure that any business transfer is made for a reasonable commercial price.

It is recommended that before transferring assets out of an insolvent company that legal and accounting advice be obtained to ensure that the transaction is not clawed back as either an uncommercial transaction or a director-related transaction.

25. How does the Fair Entitlements Guarantee treat employees when a business is transferred?

The Government in some cases, provides assistance to people who are owed outstanding employee entitlements following the insolvency or bankruptcy of their employer. This help is available through the General Employee Entitlements and Redundancy Scheme (GEERS) if the employer entered liquidation before 5 December 2012 or the Fair Entitlements Guarantee (FEG) if the employer entered liquidation on or after 5 December 2012.
FEG is a legislative scheme set up by the Government to act as a last resort for employees whose employers have become insolvent. Under FEG, employees are paid:

- up to 13 weeks of unpaid wages;
- annual leave;
- long service leave;
- payment in lieu of notice (up to 5 weeks); and
- redundancy pay (up to 4 weeks per full year of service).

Under the *Fair Entitlements Guarantee Act 2012,* employees must meet all the following requirements to be eligible for assistance under the FEG:

a) the person's employment by a particular employer has ended;
b) after the commencement of this law, an insolvency event happened to the employer;

[60] Australian Government 'Welcome to the Ideas Boom' Fact Sheet 8 Insolvency Reform.

c) the end of the employment:
   i. was due to the insolvency of the employer; or
   ii. occurred less than 6 months before the appointment of an insolvency practitioner for the employer; or
   iii. occurred on or after the appointment of an insolvency practitioner for the employer;
d) the person is (or would, apart from the discharge of the bankruptcy of the employer, be) owed one or more debts wholly or partly attributable to all or part of one or more employment entitlements;
e) the person has taken steps, so far as reasonable, to prove those debts in the winding up or bankruptcy of the employer;
f) if the person was owed any of those debts before the insolvency event happened, the person took reasonable steps before that event to be paid those debts;
g) when the employment ended, the person was an Australian citizen or, under the *Migration Act 1958*, the holder of a permanent visa or a special category visa;
h) an effective claim (see section 14) that the person is eligible for the advance has been made to the Secretary by or on behalf of the person.[61]

There are also categories of people that are excluded from eligibility under the FEG scheme including directors and relatives of directors. This means that business owners will be unlikely to utilise FEG.

26. What does the licensing of a business mean?

The concept of licencing is often critical to pre-pack arrangements because it allows a Newco to commence trading a business before an insolvency appointment so that the liquidator or voluntary administrator can ratify a final transfer after their appointment. This is the key foundation of the UK pre-pack regime, although it is not formally recognised in Australia, licencing remains a useful tool.
The licensing of a business occurs when one party (licensor) grants permission for another party (licensee) to use the licensor's intellectual property rights, plant and equipment, employees, premises and business undertaking conditionally.

Businesses often use licensing as a marketing and brand extension tool to expand their business. In a successful licensing scenario, the business that owns the assets is able to maintain control over brand image and how it is portrayed and in addition, the business receives the benefit of additional revenue in the form of royalties, business exposure in new channels and new opportunities for business expansion. Franchising is a form of business licencing.

A licensing agreement is the document that sets out the terms of the licence. It is a legal contract between two parties, known as the licensor (party leasing the business) and the licensee (party leasing from the licensor). Pursuant to the licensing agreement, the licensor grants the right for the licensee to use the licensor's property, for example brand name or trademark or the patented technology owned by the licensor, and in exchange the licensee

[61] Section 10 Fair Entitlements Guarantee Act 2012 (Cth).

accepts conditions regarding the use of the property and payment for utilisation of the business assets.

At any point during the term of the license, the licensor could become insolvent and an administrator or liquidator appointed. However, when an administrator or a liquidator is appointed to the licensor company it does not give the administrator or liquidator automatic termination of the license, unless provided for under the terms of the license.

If Oldco is put into administration the landlord may recover Oldco's property by taking possession, by entering into or assuming control of the property, pursuant to section 441F of the Act. The exception to this rule occurs if the property is considered for the purpose of administration under the Deed of Company Arrangement, the court can then order that property is not to be taken into possession. If the lessor takes no action before the administration of the lessee company, under section 440C they cannot take possession of the property, except with the administrator's written consent or leave by the court. To remedy the issue Newco usually agrees with the landlord to pay current rent during the period of the licence.

The takeaway is that where it is not feasible to transfer all useful business assets before a liquidator or administrator is appointed a licence agreement can provide an immediate solution to ensure business continuity and avoid a liquidation fire sale.

27.

What types of finance are available for a pre-pack insolvency?

Type of Finance	Security	Typical Providers	Typical Interest Rates (*range)*	Loan Purpose
Receivables finance	Purchase of receivables is required. The financier may also require a general security agreement	Niche finance providers and banks	12% on drawn funds, with a further 3% on total invoice value plus other fees and charges	Promotes cash flow and protects business from delayed payment from debtors. Also outsources collections.
Equipment finance	At a minimum security taken out over the relevant equipment	All major banks, as well as various smaller finance providers	Varies depending on risk (7%-15%)	Provides finance for the purchase of new equipment
Personal loan	Largely unsecured, dependent on provider, sometimes residential or commercial property or business assets are required	All major banks, as well as various smaller finance providers	(8%-22%)	Provide funds, lent to Director for working capital
Credit card	No security required	All major banks	(14%-22%)	Varied
Bank overdraft	Dependant on provider, sometimes residential or commercial property or business assets are required	All major banks	(8%-20%)	Gives business a solution to short term liquidity crises

Mortgage finance	Residential or commercial property	All major banks	(5%-9%)	Provides funds secured by real property, often residential property
P2P Lending	Varies from lender to lender	Think Cats Australia, OnDeck, Marketlend	(8% - 17%)	Connects borrowers with individual lenders through online platform
Friends, Fools and Family	Not required	Parents, extended family, friends	N/A	To provide necessary funding to the business

Receivables finance

Receivables finance (also called debtor finance or discounting invoices), is the purchase of a company's debts that facilitates the company to receive income from their invoices as soon as they are issued, rather than waiting for clients to pay at the end of often long payment cycles. Banks and other lenders who offer receivables finance advance to a company a percentage of the invoice amount after it is issued, alleviating many of the issues that come with poor cash flow. Often receivables financing is attractive to small businesses as there are minor credit requirements on the borrower. A receivables financier will be primarily interested in the quality of the debt that is owed to the business rather than the profitability of the business itself.

Receivables financing can be divided into two separate categories. The first category is not visible to the debtor. In this form the business receiving the finance obtains money from the financier on the presentation of an invoice and the financier decides whether or not to fund the invoices on an individual basis. The invoice is still remitted to the company however, and the company remains responsible for their own collections and for paying back the money to the financier.

The second category is visible to the debtor and the market. This is the form of financing typically provided by smaller finance providers who specialise in receivables finance. The receivables are normally assigned to the financier in their entirety. The financier then advances a percentage of funds (usually 60%-80% of the invoice value) to the borrower against the invoices as they are issued. When the invoice is paid in full the remainder of the funds are paid to the borrower, minus interest and fees. In this category the invoices are actually remitted to the financier with the monies being paid into an account controlled by the financier. Therefore, the financier also takes charge of collections. This style of financing is attractive to businesses wishing to outsource their collections and focus on their core profit making activities.

Receivables finance can also be used for Newco to immediately obtain a sum of money in order to provide consideration for the purchase of Oldco. This will help a director to limit the amount which they may need to provide security for, or borrow in their personal capacity, but it will reduce the ability of Newco to purchase inventory without further funding. Unlike many other forms of finance that may be available, this will not necessarily require Newco to put up any collateral as security, which can be a major advantage. However, as with any type of finance, it does come at a cost, with companies that provide receivables financing generally charging relatively high fees, as well as charging high interest on the amount that is advanced. There are also penalties involved if Newco's debtors are slow in repayments.

Summary
Advantages of Receivable Finance: Improves cash flow, credit checks performed on debtors rather than borrower, No restrictions on what funds are used for
Disadvantages of Receivables Finance: High rate of interest, potentially damage business relationships by having collections conducted by third party
Current Providers of Receivables Finance: Cashflow Finance, Scottish Pacific.

Equipment finance

Equipment Finance is finance granted with security taken over a business's physical assets. As security is provided it generally has a lower interest rate than unsecured borrowing, however it will have a higher rate of interest than borrowings secured by real property. For example, equipment financing could be used to purchase cars for sales representatives, plant or machinery necessary for the production of a business's product or computers for an office. In a pre-pack scenario Newco could request the novation of the loan to ensure the conveyance of the equipment from Oldco to Newco.

The structure of equipment finance can vary greatly, with some being lease back arrangements where the bank retains title of the purchased equipment, with others having the business retaining title while the bank retains a security interest. Typically the lender will also require the directors to provide personal guarantees in order to secure an equipment finance loan.

Summary
Advantages of Equipment Finance: Reduced interest rate as security provided, very useful for purchasing new plant and equipment
Disadvantages of Equipment Finance: Restriction on what money can be used to purchase, personal guarantee
Examples of Current Providers of Equipment Finance: All major banks

Personal loan

A personal loan taken out in the name of a director can be a convenient way to raise money for a business quickly. It can be used in times when cash flow is poor in order to boost funds for the company, and is also potentially a source of funding for the purchase of Newco from

Oldco. However, because this loan is taken out in a personal capacity it adds a degree of risk.

Personal loans are also offered by lenders of “last resort”. These loans have very high interest rates, with rates sometime being as high as 55% per annum and often with significant additional fees. Even personal loans from major banks have high interest rates with unsecured personal loans from banks and credit unions having rates ranging from 9% to 22%.

Taking out a personal loan for a business should be avoided if possible as it exposes the company director to the kind of personal liability and financial risk that use of the corporate form is designed to minimise.

Summary
Advantages of Personal Loans: Access to funds that are otherwise unavailable and speed
Disadvantages of Personal Loans: High rate of interest, personal liability
Examples of Current Providers of personal loans: All major banks, GE Money, Rate Setter, RACQ, Society One, Various credit unions.

Credit card

A director’s personal credit card or a credit card in the name of the business can be a source of finance for a business.

Credit Cards are an attractive source of finance as:

a) The money provided by a credit card is flexible, there are no limitations by the bank on how the funds can be spent.
b) The money is easily accessible, with credit cards being accepted by most suppliers

As credit card interest rates are often around 20% per annum this should be treated as a last option and should not be used for debt that will not be paid off promptly. The interest rate charged is further amplified because credit cards interest compounds monthly. This effect is further multiplied if one card is being used to pay off the interest on another.

Summary
Advantages of a Credit Card: No restrictions on what money is used for, money easily accessible.
Disadvantages of a Credit Card: Very High interest rate, Director typically personally liable.
Examples of Current Providers of Credit Cards: All Banks.

Bank overdraft

A bank overdraft can be an effective way for a business to access finance. An overdraft, like a credit card, gives a business access to a set amount of funds. Rather than being tied to a repayment schedule, as with a personal loan, the business pays interest on funds that are

withdrawn at regular dates (i.e. monthly). This has the advantage of allowing the business to keeps their repayments to a minimum during times of stress. As an overdraft is typically continually available, it can be applied for during a time of financial stability, with funds then being available during a short term crisis.

An overdraft is typically attached to a business transaction account. As the facility is offered by a bank the approval process is more onerous than with niche financiers. It is also common for the bank to require the directors of the company to provide personal guarantee's to secure any amounts borrowed. Interest rates for an overdraft are also relatively high, with rates of around 15% being common where no additional assets have been given as security.

Summary
Advantages of a Bank Overdraft: Flexible facility – only borrow the amount needed, always available
Disadvantages of a Bank Overdraft: High rate of interest, personal guarantee
Examples of Current Providers of a Bank Overdraft: All Banks

Inventory finance

Inventory finance is financing which is provided to allow a business to purchase their inventory with repayment being made once the product has been sold to the end customer. This kind of finance can be particularly useful when a business is starting up as it can be used to fund the initial purchase of inventory.

Typically with this kind of finance, because the assets will not be staying in the possession of the lender, the financier will require a personal guarantee from the directors of the company.

Summary
Advantages of Inventory Finance: Allows for purchase of inventory.
Disadvantages of Inventory Finance: not available to all industries, interest charges accruing during production process.
Examples of current providers of inventory finance: most major Banks, although this often limited to particular industries.

Family, Friends and Fools

Borrowing from friends, family or fools (*FFF)* is attractive for a number of reasons. The main reason in that FFF's are unlikely to require security or to charge a high rate of interest. FFF's are also not in a position to run credit checks or to carry out due diligence on the assets of the business. FFF's are also unlikely to understand the risks involved in making the proposed loan.

Rather than taking on debt, one strategy is to ask a FFF to invest in the business and in return give them shares. This has the advantage of meaning the business will only need to pay the FFF if it is making a profit and paying a dividend.

However, funding from an FFF is not available to all and may impact adversely on personal relationships if a company faces financial difficulty.

Summary
Advantages of Friend, Families and Fools: Low interest, limited credit checks, unlikely to require security.
Disadvantages of Friends, Families and Fools: Potential negative impact on close personal relationships.

Mortgage Finance

Mortgage finance is finance provided in return for security granted over property. Some businesses have sufficient property of their own to secure borrowings, but if a business has limited assets, lenders will often require a mortgage over the real property of the directors. As with a personal loan, this should be avoided if possible as it increases the risk of personal loss to the director if the business is unsuccessful. There is also a danger to the director's family as their home may be in jeopardy of repossession if the business fails.

There is one very significant advantage of a loan secured by residential property. These loans will generally attract the lowest rates of interest with some finance currently available at interest rates approaching 5% per annum. This rate of interest is very low historically with mortgage interest rates when compared to other forms of finance.

Summary
Advantages of Mortgage Finance: Low rate of interest.
Disadvantages of Mortgage Finance: Puts personal assets at risk.
Current providers of Mortgage Finance: All banks.

Peer-to-Peer (P2P) Lending

P2P lending is a new platform for lending that uses online platforms to connect individual non-bank lenders to borrowers. Morgan Stanley has predicted that by 2020 the P2P lending to businesses in Australia will increase to $11.4 billion.

P2P lending is attractive to small business lenders as these platforms will often require less paperwork from borrowers. P2P lenders will also place less onerous conditions on a loan than a bank will. The interest rates are typically between 10-15%, but can vary substantially because platforms have a competitive bidding process for a borrower's loan. The term of the loan can range from 6 months to 5 years, with loan amounts available ranging between $2,000 and $2,000,000.

One potential downside for borrowers is that, at present, P2P lending is a lightly regulated section of the market, and as such there is potentially more scope for unethical behaviour. There is also frequently a loan application fee which must be paid, with no guarantee that the loan will be made. Some P2P lenders will also only offer financing for certain things, for example ThinCats Australia will only provide funding for business growth.

Summary

Advantages of P2P Lending: Gives access to alternate sources of funding, speedy application process, Limited security needed, and competitive loan tender process.
Disadvantages of P2P Lending: unregulated industry, relatively high rate of interest, ancillary charges.
Current Providers of P2P lending: Thin Cats Australia, Marketlend.

28. Why are pre-pack insolvency arrangements common-place restructuring transactions in the UK but not in Australia?

In the UK a pre-pack administration sale is a commonly utilised, and legal business rescue technique. It allows a business to be sold to the existing directors through a new entity. Pre-pack arrangements are relatively common in the UK, where administrators arrange the sale of a business or company prior to the entity going into administration. In order to facilitate a successful pre-pack arrangement, the sale of a business, and or assets of an insolvent company, is agreed to prior to the appointment of an insolvency practitioner. The practitioner's task once appointed is then to review the sale terms, and if legal and appropriate, to ratify the sale.

Under the UK pre-pack arrangement regime most businesses are sold as a going concern, with the company's assets and undertaking sold together. Whilst in a prepack scenario, a company can continue to operate the business, often leaving employees and customers completely unaware of the situation until after commencement of voluntary administration.

One of the main obstacles in implementing a mirrored UK system here in Australia arises out of Australia's stricter legislative regime. Under the Act once an administrator is appointed, a creditors meeting is held where, amongst other things, the fate of the company is decided. Using the approach utilised in the UK, the fate of the company is already decided prior to the appointment of the administrator, and without the input of creditors.

Australia has significantly stricter insolvency laws than that of the UK, proving another obstacle to the adoption of the UK pre-pack model. Additionally, insolvency practitioners in Australia are subject to strict codes of conduct. Essentially, insolvency practitioners are not permitted to have "substantial prior involvement" with a company to which they are later appointed. If a conflict arises in relation to the prior involvement of a practitioner in Australia the practitioner may be removed from the matter by court order. In the UK however, replacement of an insolvency practitioner is taken as a last resort as the conflict is often believed to be manageable. There is no policy backing for Australia to adopt a UK-style pre-pack regime.

29. What standards of valuations do courts expect for pre-pack insolvency arrangement?

There is no consistent line of reasoning that the courts have applied regarding the standard of valuation required in a pre-pack insolvency arrangement. This makes sense because the quality of the valuation report and the methodology that is appropriate would vary depending on the industry and size of the business. For example in many micro-businesses that have

no maintainable earnings (in the absence of the proprietor) it would not be appropriate to value the business as a multiple of net earnings. That business may be valued by the break-up value of the assets.
The case study set out below found that except where there is a sham transaction, the standard applied by courts for the valuation of a business is a low bar. The Court found that as the transfer was not uncommercial it declined to set aside the transfer from Oldco to Newco.

In a pre-pack insolvency arrangement it is expected that Newco acquires the business assets of Oldco for value. It is essential for commercial value to be paid to avoid a liquidator making a claim for an uncommercial transaction against Newco or an unreasonable director-related transaction claim against the directors of Oldco.

The valuation methods broadly used are:

- Liquidation value;
- Fair market value; and
- Discounted cash flow value (multiple of maintainable earnings).

In any liquidation scenario potential purchasers will expect that assets are sold at “fire sale” prices. Liquidation value is the likely price of an asset when insufficient time is allowed to sell it on the open market, thereby reducing its exposure to potential buyers. Liquidation value is typically lower than fair market value.

Fair market value (FMV) is an estimate of the market value of a business, based on what a knowledgeable, willing, and unpressured buyer would probably pay to a knowledgeable, willing, and unpressured seller in the market.

Valuing a business as a multiple of maintainable earnings or discounting the cash flow is the most common method for valuing a business. It is also referred to as the discounted cash flow method. This method values a business by taking into account risk and discounting the expected cash flows to determine the value of the business. Each industry will have its own rule of thumb for the multiples of net earnings that is the expected market price for a business.

The multiple of maintainable earnings method is unlikely to be applied to a business which is completely dependent on the skill or relationships of the proprietor. For example, if a lawyer’s incorporated practice were to go into liquidation the liquidator would have the ownership of the practice files, WIP and debtors but not the solicitors themselves. In that case a valuation methodology based upon a multiple of maintainable earnings would be inappropriate as the lawyer could recommence practice through another firm and continue to act for the clients. In that case the value of the assets (being the files and WIP) would be calculated separately to the expected cash flows of a business.

Case study: What is an uncommercial pre-pack?

In the case of the *Skouloudis Group*[62] a liquidator sought to set aside a transfer of a business shortly before a winding up petition against the company was determined.

Mr Skouloudis was the proprietor of the newspaper called O Kosmos through his company Skouloudis Group Pty Limited (i.e. Oldco). The company was in dire straits and the newspaper business was the principal asset of the business. It was acknowledged by Mr Skoudoulis that Oldco was insolvent before the business was transferred.

The liquidator of Oldco alleged that the transfer of the business was uncommercial and relied upon a list of indicia to prove their case. Both parties also agreed that the company was insolvent at the time of the transaction and that the purchaser was a related party.

A transaction is an uncommercial transaction if, and only if, it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction.

Why did the liquidator allege that the transaction was uncommercial?

The elements of the transaction that the liquidator sought to challenge were:

- There was no written contract and no ascertainable sale price but critically the liquidator didn't allege it was a sham. The liquidator alleged that there was a transaction but that it was uncommercial.
- The director transferred all the assets and undertaking of the business from Oldco to Newco including the newspaper business, equipment, assignment of the lease, employees, intellectual property, advertiser lists, and everything necessary to run the newspaper.
- The purchase price was unspecified and it included taking over some liabilities of Oldco including staff entitlements, rent and printing costs. There is no reference in the judgment regarding whether OIdco's tax debt was paid but it may be assumed it was not paid by Newco.

The focus of the Court was on the liquidator proving that the transaction was uncommercial. The Court found that because it was a related party transfer it should be looked at closely. The transaction involved Mr Skouloudis transferring the business to a company owned by his wife.

The Court was critical of the lack of evidence relied upon by the liquidator and found that the low purchase price, lack of documentation of the transaction and the related party purchaser did not necessarily make the transaction uncommercial.

The Court was not satisfied that the purchase was uncommercial and found that the transaction was "not necessarily an unreasonable transaction". The Judge found:

[62] Skouloudis Group Pty Limited v Planet Enterprizes Pty Limited [2002] NSWSC 239

> *If the newspaper business was the only asset of the company which it held beneficially, as appears to be the position, and if the company was unable to pay the debts of that newspaper business as appears to have been the case, then the disposal of that business for a sum sufficient to pay the liabilities, which the company was unable to pay was not necessarily an unreasonable transaction.*

Because the liquidator didn't prove the transaction was uncommercial they lost the case.

The lesson is that the courts are not usually interested in second-guessing commercial decisions unless there is a good reason to do so. When the provision allowing for the claw-back of uncommercial transactions was introduced into corporate law the explanatory memoranda summed up its purpose:

> *"The provision is specifically aimed at preventing companies disposing of assets or other resources through transactions which resulted in the recipient receiving a gift or obtaining a bargain of such magnitude that it cannot be explained by normal commercial practice."*

Therefore in Skouloudis Group, the liquidator could have likely succeeded by arguing that the transfer of the business was a sham and that there was no binding contract, the business was simply given away.

To avoid a liquidator's claim the principal requirements for a transfer of a business from Oldco to Newco are:

- Valuation of the business; and
- A sale of business contract or asset sale agreement

One insolvency firm that specialises in pre-pack advice has recommended that the sale price of a business in a pre-pack should be somewhere between the auction value (i.e. a fire sale) and the going concern value, however, the case of Skoulooudis Group does not support the proposition that the sale price need necessarily be that high.[63]

Crouch Amirbeaggi have developed a pre-pack process as follows:

1. Pre-appointment review is undertaken of insolvent company by the insolvency practitioner;
2. Conditional sale agreement is executed and licence agreement to allow business to continue to trade through Newco;
3. Sale price agreed as the midpoint between the "auction" and "going concern value" of the business but it is not finalised until a valuation and public sale process by the liquidator;
4. The liquidator is appointed and advertises the business for sale;

63 "Pre-Packs: A Legitimate means to Phoenix an Insolvent Company" Crouch, N & Amirbeaggi, S. (2011) 23(1) A Insol J 30-35.

5. If the liquidator receives an offer to buy the business from a member of the public the director of Newco will have the right to outbid it.

The obligations of the director of Newco are to attend to the following tasks after the appointment of the liquidator:

- Obtain a valuation of plant and equipment;
- Obtain a Work Health & Safety report of the trading premises;
- Provide details of the current insurance policy;
- Complete a stock take;
- Prepare accounting information for the sale of business information memorandum;
- Prepare business for sale advertisements; and
- Provide names and addresses of all staff and creditors.

The takeaway is that the benefit of a pre-insolvency advisor is assessing whether a pre-pack insolvency arrangement will save the business and its proprietors more value (and money) than self-help.

30. Are pre-pack insolvency arrangements possible if there are secured creditors?

A secured creditor is a creditor who has received security over some or all of the assets over a company in return for borrowed funds. This security will come in the form of either a mortgage over real property, or a security interest in specific personal property or a general security agreement over all the personal property (all present and after acquired property). If a secured creditor is not paid the money owed to it, the principal enforcement remedy it has is to appoint a receiver. The task of the receiver is to take control of the secured property and sell it to repay the secured creditor's debt. A receiver can only be appointed however if the instrument giving rise to the security grants the lender the power to appoint a receiver. The powers of the receiver will also be limited to what is granted either the Act and under the security agreement.

Where the security is held over real property (land) the consent of the secured creditor will be necessary before the asset can be transferred from Oldco to Newco. Personal property which is subject to a security can be transferred without the consent of the secured creditor, however the security generally survives the transfer and the secured creditor can take steps to enforce their security. As a result, to avoid action by the secured creditor, it will be necessary to transfer the liability to the secured creditor from Oldco to Newco, in order to avoid assets being seized and have the consent of the secured creditor.

Upon the appointment of a liquidator, a bank will generally engage with the liquidator but it is open for the bank to appoint a receiver over the top of the liquidator. The receiver takes control of the assets of the company subject to the bank's security and the liquidator is left with an empty shell. However, if the bank is satisfied with the methodology of the pre-pack, and is satisfied that the business has been purchased for a fair price, they are less likely to appoint a receiver. The key is for the pre-pack advisor to communicate with the bank before

implementing a pre-pack to avoid the reversal of the transaction after a liquidation commences or the transfer of the assets is executed.

It is clear that for any pre-pack of a company with secured creditors to be successful, the secured creditors will need to consent to the transfer of assets and approve the sale of the business. If this support is not obtained, it is likely that a receiver will be appointed and take measures to enforce the security and frustrate the sale.

31. What operational improvements can result from a pre-pack insolvency arrangement?

There are typically five root causes of SME insolvency;

1. Poor management: The business has been poorly operated by its management.
2. Big project: Entrepreneurs are typically optimistic about the success of their business. This can lead to big projects being taken on with inadequate market information or overly optimistic projections for timeframe, revenue, expenses and profits.
3. Poor financial information: Often SMEs do not have the financial information necessary to accurately judge how the business is progressing. When this is allowed to continue for a period of time the SME may find itself in an unexpected cash flow crisis.
4. Overtrading: Business growth costs money in the form of working capital and these requirements need to be properly estimated and provisioned for in advance.
5. Add a predictable risk event: An otherwise predictable risk event could cause a business to fail because it is already vulnerable from one of the above 4 root causes.

A pre-pack insolvency arrangement is a structural change of the business but it can be part of significant operational change to ensure that the business is viable. A pre-pack is a structural change because the legal organisation of the business is changed and the nexus of contracts that keeps the business together are varied, terminated or novated. It does not directly change the operational nature of the business, and strategic thought may be required to address the cause of the business collapse, such as poor management, in the medium-to-long term.

There are a number of ways the business can be changed through the pre-pack process to facilitate operational change. One way is for Newco to only acquire those parts of Oldco which are profitable. This results in Newco being a newly efficient enterprise, with the less profitable or loss making parts of the business being left for the liquidator of Oldco to wind up.

Where a problematic big project has led to a cash flow crisis, the pre-pack can allow for the termination of the big project or transfer of the profitable elements into the new trading entity. The pre-pack arrangement also creates an opportunity for the business to start from scratch with improved business measurement and financial tools. Where a big project has involved optimistic assumptions, these assumptions can be revised. The new company can take a fresh approach to managing its financial information to achieve more accurate knowledge of the business's financial position. More accurate reporting will allow the business to improve

its business metrics, such as return on investment and asset utilisation. A more thorough understanding of the business's financial performance will also allow management to eliminate unnecessary expenses and focus on profitable services or products.

This operational turnaround can result in global change for the business with a completely new strategy and vision for the new trading entity. Alternatively change could be restricted to a micro level with the addressing of issues such as the termination of underperforming staff.

Most importantly a pre-pack can create the breathing space necessary for managers to review their performance and the performance of the business. Rather than spending their time responding to demands from creditors, managers would be able to review their processes and improve those parts of the business which contributed to the business's cash flow crisis. It is important at a pre-pack stage for the end game of the business to be defined.

32. Are pre-pack insolvency arrangements possible if premises and/or plant and equipment are all leased?

There are two separate categories of leases which will need to be addressed in a pre-pack insolvency arrangement, premises and equipment. The takeaway is that the consent of the landlord and equipment financiers will likely be required in a pre-pack insolvency arrangement.

Lease of Premises

An important part of negotiating a pre-pack insolvency arrangement may be a negotiation with a landlord to allow the business to continue operating from its premises. An assignment of the lease from Oldco to Newco has some commercial advantage for the landlord as it allows for continuity and stops the landlord from losing a tenant.

Fixtures to the property are generally considered to be the landlord's property and can be transferred with the lease. Fixtures include anything that is attached to the property (being held down by more than its weight), unless there is a right of removal in the lease. Anything not attached is a chattel and is personal property. Separate arrangements need to be made for the transfer of chattels from Oldco to Newco.

When negotiating for the assignment of the lease it will be necessary to re-negotiate any bank guarantees that may have been given by Oldco to the tenant. It is not preferable to have the landlord return the bank guarantee to Oldco before the appointment of a liquidator. If the bank guarantee is returned after the appointment of the liquidator the funds may be held by the liquidator.

It is preferable that the lease be assigned before the appointment of the liquidator, as this will allow for the transfer of the bank guarantee (and its replacement). It is also possible to sign a new lease with the landlord after a liquidator has been appointed to Oldco because they can then disclaim Oldco's lease.

If there is a valuable fitout of the premises, as could be the case with a business such as a restaurant or a retail store, it may be necessary to delay the sale of the business until after the appointment of the liquidator. It may be necessary to convince the liquidator that the valuation of the business has made adequate provision for the value of the fitout. If the sale

of the business is made before the appointment of the liquidator and the liquidator is not satisfied that the value of the fitout has been included, the liquidator may attempt to challenge the transaction. In this instance the director may be protected by a properly prepared valuation in support of any business transfer and related assignment of a lease.

Lease of Equipment

Any equipment, which is not a fixture, and is leased from a financier, will need to be transferred from Oldco to Newco to fully effect the pre-pack. Negotiation with financiers to facilitate this is a key part of negotiating a pre-pack arrangement.

One of the main challenges with this process will be getting the attention of the financiers. Many financers, in particular larger financiers, may not be interested in assisting with a pre-pack arrangement, as they do not want to spend the time on what they would consider to be a relatively small matter.

If the pre-pack insolvency arrangement is to be finalised after the appointment of the liquidator it will be useful if the leased equipment has a balloon payment. A balloon payment is a large payment that is payable at the end of the lease in return for the leased goods. It has the effect of reducing the payments that need to be made during the life of the lease. It also has the effect of reducing the equity available in the leased goods for the liquidator. As they will be unable to gain any benefit for creditors by maintaining the lease themselves the liquidator is likely to agree to the novation of the lease in circumstances where there is a balloon payment. If there is not a balloon payment, the residual value of the leased assets may need to be taken into account when valuing the business to avoid claw back action by the liquidator.

33. What do the courts regard as a sham or fraudulent transaction?

Sham and fraudulent transactions have been a common focus of the law for centuries. Diplock LJ determined in *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786 that sham can be defined as:

> *"..acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create."*

Although there is no provision in corporate law or elsewhere that expressly uses the term phoenix activity, the fraudulent form of the behaviour will always be a breach by the director of their duty to act in good faith in the best interests of their company, and for a proper purpose,[64] and not to improperly use their position to make a gain for themselves or someone else, or to cause detriment to the corporation.[65]

Offences of fraud are committed where a person obtains property from another by a dishonest act of deception. Section 192E of the *Crimes Act 1900* (NSW) determines that a Fraud is a person who, by any deception, dishonestly obtains property belonging to another,

[64] Corporations Act (2001) (Cth) s 181.

[65] Ibid s182.

or obtains any financial advantage or causes any financial disadvantage. In order to commit an act of fraud, the deception must be intentional or reckless in nature.

Hill J in *Faucilles Pty Ltd v FC of T* [1989] FCA 791 considered that a sham transaction is one which is intentionally created to have no legal effect, if there is a common intention of the parties that the transaction should be a cloak or disguise for another transaction, or no transaction at all.

A transaction is a sham where the parties to the transaction act with a common intention not to create legal rights and obligations, although the transaction on face value, gives the appearance of creating those legal rights and obligations.[66]

Sham transactions are legally ineffective; however it is important to note that not all ineffective transactions will be considered shams even if illegality is an element.[67]

There are many examples of sham or fraudulent transactions that have been entered into by insolvent companies. Such as in *R v Heilbronn*[68] where the director of a company with substantial sales tax liabilities, stripped the company of its assets and transferred them to another company, and then to a third company. On each occasion, the same business was carried under the same trading name. A proper price had not been paid for the assets, and no effort was made to ensure the liabilities and other legal obligations had been met.

For a court to establish that a sham or fraudulent transaction has taken place, it must decide whether the parties to the transaction intended to mislead third parties by the execution of the documents that were purported to create the legal rights and obligations relied on by third parties.

Simply put, just because an agreement produces a result that the creditors do not like, or may seem as though the agreement was entered into for the purpose of improving one person's position unfairly against another person, it does not entitle the court to conclude that a sham transaction has occurred. A sham is pretence and it involves the court finding that the real agreement entered into by the parties is something other than what is appears to be on the face of the documents.

It is vital that all documents prepared for a pre-pack arrangement should be properly drafted legal documents with an arguable commercial benefit. Failure to prepare documents may cause a pre-pack to be set aside by a liquidator.

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[66] *Bayly v FC of T* (1997) 15 SASR 446.
[67] *Lau v FC of T* (1984) 54 ALR 167).
[68] *R v Heilbronn* (1999) 30 ACSR 488.