What you need to know before you pre-pack (to avoid phoenix activity).

By Ben Sewell, Sewell & Kettle Lawyers

Date of update: July 2020

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

Overview

1. What is a pre-pack insolvency arrangement?
2. Who should read this White Paper?
3. What is a pre-pack voluntary administration?
4. Who is a pre-pack insolvency arrangement suitable for?
5. What is the safe harbour from insolvent trading?
6. What is phoenix activity?
7. Why is the ASIC, the ATO and Department of Employment becoming more active in pursuing phoenix activity?
8. What is the difference between a secured and an unsecured creditor?

Insolvency issues for SMEs

9. What are SMEs and why are they important?
10. What financial and operational issues do SMEs face?
11. What is the legal meaning of insolvency?
12. What are the indicators of insolvency recognised by Courts?

Directors and advisors of SMEs

13. What are the principal legal duties of directors?
14. What is insolvent trading?
15. How does a director get a safe harbour protection from insolvent trading?
16. Why do directors need to watch out for Director Penalty Notices (DPNs) from the ATO?
17. What penalties can directors face for insolvent trading and breach of duty?

18. What immediate actions should directors of an SME take if their company is insolvent?
19. What types of professional advisors assist with a pre-pack insolvency arrangement?
20. What are the duties of professional advisors advising insolvent SMEs?

Liquidators of SMEs

21. Who are liquidators and what do they do?
22. What is the downside of a liquidation firesale?
23. When can a liquidator claw back transactions made to related entities, including a new company?
24. What factors do liquidators take into account when they decide whether to pursue illegal phoenix activity?

Voluntary administrators of SMEs

25. What is voluntary administration?
26. Why do SMEs appoint voluntary administrators?
27. What are the downsides of voluntary administration?
28. Why is voluntary administration impractical for a microbusiness (1-4 employees)?
29. Are insolvency practitioners under a conflict of interest when advising on a pre-pack voluntary administration?
30. What are the future prospects of voluntary administration: are results improving or declining?

Restructuring of SMEs

31. What is informal restructuring?

32. How does a director obtain safe harbour protection from insolvent trading?

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

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

35. How does Fair Entitlement Guarantee treat employees when a business is liquidated?

36. If employees are transferred from a company in liquidation, do employee entitlements transfer?

37. How can directors be penalised for phoenix activity and utilising FEG to pay outstanding entitlements?

38. What does the licensing of a business mean?

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

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

41. What standards of valuation do courts expect for pre-pack insolvency arrangements?

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

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

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

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

46. Capstone comment: Why is it difficult to successfully execute a pre-pack insolvency arrangement?

OVERVIEW

1. What is a pre-pack insolvency arrangement?

The market for insolvency services is shrinking, 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. There has been 25 years without a recession and financiers are generally reluctant to appoint receivers so there is simply less work for insolvency practitioners.

The pre-pack insolvency arrangement is an opportunity to achieve a business rescue without the cost and disruption of a voluntary administration. It is an example of an informal work-out methodology.

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” schemes and now “phoenix activity” contrast with legal pre-pack insolvency arrangements. The purpose of this White Paper is to help professional advisers to understand alternative approaches to informal work-outs without resorting to phoenix activity.

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 both poor quality and illegal advice that can lead to phoenix activity.

The essential preconditions for a pre-pack insolvency arrangement are that a business is insolvent and that the directors have an intention to restructure their affairs to rescue the business. Pre-packs may 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) so sole traders and partnerships are not discussed in this paper. 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 in an optimal outcome for stakeholders.

There are two types of pre-pack insolvency arrangements:

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

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

The pre-pack insolvency arrangement is not widely utilised in Australia but it has been recognised as a valid methodology by courts, the legal 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]

The insolvency profession is generally against promoting or utilizing pre-pack insolvency arrangements. The focus of the Australian insolvency regime has been to have an independent insolvency practitioner appointed over insolvent companies through a formal restructure process (i.e. a voluntary administration). It is understandable that insolvency practitioners would resist informal arrangements, because it results in less profitable work and a loss of control over the insolvency process. However, professional advisers should be aware that if a company is insolvent, at some point in time it may ultimately be placed in liquidation and at that time the insolvency practitioner appointed will have the task of reviewing the pre-pack insolvency arrangement. Therefore, it is essential for any director undertaking an informal work-out and asset transfer to strictly comply with their legal obligations or they may face a claw-back action by a liquidator down the track.

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 illegal advice has expensive consequences of personal liability for tax debts and the continuation of unsustainable business. It is not in anyone's interest to continue a loss-making business and directors are better off doing something else!

SMEs are businesses employing less than 200 people and 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 of business" approach to identify obstacles including personal, operational

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

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

and financial difficulties that their clients face. This information should then be utilised when developing a rescue strategy.

This White Paper 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 and corporate law, and market realities faced by SMEs.

Best of luck working on your turnaround! On the other hand, remember that you can arrange for an orderly liquidation through the safe harbour protection in the event that a pre-pack insolvency arrangement isn't feasible.

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. Valuations would have already been obtained, contracts drafted and the sale price agreed upon 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. The directors put a proposal for a deed of company arrangement *(DOCA)* to the voluntary administrator. It was the intention of the creators of voluntary administration that the appointed insolvency practitioner would take "full control" of the insolvent company's property.[2] It was not contemplated by the creators of voluntary administration that directors would execute a pre-pack before appointing a voluntary administrator because the DOCA proposal was intended to cover the entire restructure of an insolvent company.

[2] General Insolvency Inquiry (1988) The Law Reform Commission Report No 45, para 79.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

After assessing the viability of the business, the voluntary administrator decides whether to continue trading under the business during the administration period or to 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 DOCA is the primary binding instrument between the creditors, directors and the voluntary administrator for any compromise arrangement made. A DOCA proposal is subject to a vote of creditors and therefore needs creditor support. The principal benefit of a DOCA for the directors is that the company does not go into liquidation and therefore, there are no claims for insolvent trading, uncommercial transfers or unfair preferences that can be made against them or related parties.

The obvious benefit of a pre-pack insolvency arrangement is that the directors of the insolvent business retain control of the restructure before the commencement of a formal insolvency (through a liquidation or voluntary administration). This is the case for a 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 a matter of independent judgment as to whether the voluntary administrator finalises the transaction without the approval of creditors. There may be a number or reasons why a voluntary administrator would or would not sign off on a transfer before it is voted on by creditors. One reason would be that the voluntary administrator is not convinced that the price of the transfer could not be bettered through a public tender.

There is no “bidder’s tension” in a pre-pack scenario. In a “regular” voluntary administration, the voluntary administrator will evaluate any purchase offer of the business assets and will be unlikely to approve a sale before it is considered by the second meeting of creditors.

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

Two key characteristics of an insolvent SME that qualify it for a pre-pack insolvency arrangement are:

1. That there is a serious commercial issue with the goodwill in a business being damaged by a formal appointment scenario; and/or
2. 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 when broken up. Accountants would say that goodwill amounts to the excess of the "purchase consideration" (i.e. the price 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 to Newco.

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 eliminating the goodwill value of the business. The liquidation of a company is likely to result in the total loss of a company's goodwill. To avoid such a scenario, however, 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 or voluntary administration to the suppliers and customers.

There is currently very little empirical research into the costs of voluntary administration but it may be observed that the professional costs of voluntary administration are on the rise. It may be expected that voluntary administration for an SME will cost between $50,000 and $200,000. One researcher found that even small voluntary administrations had average fees of $97,000.[3]

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.

5. What is the safe harbour from insolvent trading?

The safe harbour from insolvent trading is a protection to company directors from an insolvent trading claim run by a company liquidator. Under section 588G of the Corporations Act, company directors are under a duty to prevent their company from incurring debts whilst insolvent. This is a director's duty, and the penalty for breaching the duty includes paying compensation.

Under the prohibition, a director of a company may become personally liable for debts incurred by their company whilst it is insolvent. Broadly, section 588G provides that a director will be found to have breached their duty if:

- The person was a director at the relevant time;
- The company was actually insolvent;
- The company incurred a debt; and
- There were reasonable grounds for the director to suspect insolvency.

The penalties for a director breaching the prohibition include:

- Civil penalties of up to $200,000 (sections 1317E and 1317G);
- Liability to compensate the company or relevant creditor for the amount of the debt incurred as a result of the breach (section 588M); and
- Criminal prosecution in limited circumstances (section 1311, Schedule 3 Item 138).

---

[3] Mark Norman Wellard (2014) A sample review of Deeds of Company Arrangement under Part 5.3A of the Corporations Act ARITA Terry Taylor Scholarship, Australian Restructuring Insolvency and Turnaround Association, available at: <https://eprints.qut.edu.au/74002/>.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

The safe harbour law provides that the duty to prevent trading while insolvent will not apply when:

- At a particular time after the director suspects insolvency, the director develops a course of action that is reasonably likely to lead to a better outcome for the company; and
- The company debt is incurred in connection with the course of action.[4]

To claim the safe harbour protection there is no specific process that is mandated for a director to undertake and it is dependent on the size and complexity of the company's circumstances. But the safe harbour law includes indicators about what a course of action may involve, including the director (and therefore the board):

- Informing themselves about the company's financial position;
- Taking steps to prevent misconduct by officers and employees;
- Keeping appropriate books and records;
- Obtaining advice from an "appropriately qualified entity"; and
- Developing or implementing a plan for restructuring the company.

The key test to be considered is whether the course of action developed may be "reasonably likely to lead to a better outcome for the company" (section 588GA(1)(a)). A "better outcome" is compared to what would occur if there was to be an immediate appointment of a voluntary administrator or liquidator over the company.

There are hurdles to obtaining the safe harbour protection and these include lodging tax returns and paying employee entitlements.

It should also be noted that the safe harbour protection has recently been amended as a result of the COVID-19 pandemic. The new Coronavirus Economic Response Package Omnibus Act 2020 (the Coronavirus Economic Response Act) has come into force and contains a range of new measures to support businesses through the Coronavirus/COVID-19 pandemic and its consequences. In particular, the Act creates a new 'temporary safe harbour' which protects directors from liability for insolvent trading while they respond to the Coronavirus pandemic and its consequences. This means directors don't have to pull the trigger and appoint a voluntary administrator or liquidator, or at least not as quickly.

The take-away is that if directors take sensible steps to restructure a company informally they will be able to take advantage of the safe harbour. Directors need to develop a written plan that on balance would be likely to put the company in a better position than a liquidation or voluntary administration.

6. What is phoenix activity?

Phoenix activity is a loaded term that has connotations of fraud and acting selfishly and illegally by company directors and advisers. Unfortunately, there is no universally accepted definition in the law or an express definition in the Corporations Act that we can refer to. The reason there is no definition in the Corporations Act is that defining this concept is difficult and it would require an examination of the intentions of the directors.

[4] *Corporations Act 2001* (Cth) s 588GA.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

Phoenix activity involves:
• An insolvent company (Oldco);
• The transfer of Oldco's assets for inadequate consideration to a related entity (Newco); and
• The result is detrimental for creditors, employees and other stakeholders as they receive less than what they would have received from a voluntary administration or liquidation scenario.

There may also be a cyclical element because "phoenix operators" are the people who repeat this process for their own business or for clients who they provide sham labour hire arrangements for.

There is a recent research paper "Defining and Profiling Phoenix activity" that was released in December of 2014 that is the most thorough examination of the definition of phoenix activity by any academic to date. It is a very strong academic paper prepared by a group including Professor Ian Ramsay and Professor Helen Anderson called the Phoenix Research Team. This research is discussed further below in section 32 of this White Paper.

The report also points out, troublingly for regulators, that there is legal phoenix activity and illegal phoenix activity. They describe legal phoenix activity as business rescue. The key finding of the report is that the difference between types of phoenix activity, i.e. the types that are illegal and types that are legal, comes down to the **intention of the company directors.** They found:

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.

More recently, reforms introduced in February 2020 within the Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2019 (Cth) have helped provide a greater understanding of what illegal phoenix activity entails. The key reform was the introduction of creditor-defeating dispositions. A creditor-defeating disposition occurs when a company transfers property for less than its reasonable market value. The implementation of creditor-defeating dispositions into Australian law has helped define phoenix activity and provides a new mechanism that liquidators can use to claim assets.

Despite this reform, it is still safe to say that the definition of phoenix activity is a contested area for regulators, lawyers and academics.

7. Why is ASIC, ATO and Department of Employment becoming more active in pursuing phoenix activity?

The principal actor that investigates pre-insolvency transactions undertaken by company directors is the liquidator of the company. At law the ASIC has jurisdiction to regulate corporate activity in Australia including laws to protect creditors of companies and powers to undertake independent legal actions against company directors for breach of their duties. If there is a crime committed the matter can be referred to state or federal prosecutors.

The Australian Taxation Office (*ATO*) and the Department of Employment, Skills, Small and Family Business are both indirectly affected by corporate misfeasance and phoenix activity.

The ATO is affected due to its role as collector of taxes and the Department of Employment, Skills, Small and Family Business is adversely affected through payments under the Fair Entitlements Guarantee (*FEG*). Both have a vested interest in becoming more active in corporate insolvency although they have no direct jurisdiction or powers.

The ATO collects debts payable by companies including PAYG, income tax and GST. Although there is sparse empirical research on the topic, the ATO is usually a substantial creditor in SME liquidations in Australia. FEG is a scheme that pays employees of companies that go into liquidation unpaid employment entitlements that should have been paid by the company in liquidation.

To assist liquidators with claims against directors, both the ATO and FEG may provide funding to liquidators.

In 2016 the Minister for Employment announced that they had provided funding to the special purpose liquidator of Queensland Nickel to undertake proceedings for insolvent trading and breach of directors' duties against Mr Mensik (appointed director) and Mr Palmer (alleged shadow director). FEG paid an amount of approximately $66.8 million to 759 ex-employees of Queensland Nickel. The minister stated that this action should: "*send a very clear message to the defendants that it will take all steps it can to ensure that they face court."*

The ATO and FEG are increasing their involvement in liquidations and supporting liquidators in taking action against directors. It is likely that the ATO will attend a creditor's meeting and that the ATO and/or FEG may potentially fund a liquidator to take legal action against the directors.

Beyond this, the new creditor-defeating disposition reforms have bolstered ASIC's ability to combat illegal pheonixing activity and protect legitimate creditors by enforcing the creditor-defeating disposition provisions. ASIC now has the ability under s 588FGAA to make an administrative order at the request of a liquidator or on its own initiative stating that the property involved in a creditor-defeating disposition be returned, that the amount representing the benefit be paid or that an amount that 'fairly represents' the proceeds be paid. Any failure to comply with the order, is an offence which carries a fine of up to 30 penalty units or imprisonment of up to six months, or both. This extends the recovery provisions available to liquidators and improves their ability to recover assets lost through illegal phoenixing. The benefit is also that liquidators don't need to start litigation to recover property.

8. What is the difference between a secured and unsecured creditor?

In corporate insolvency, a creditor is broadly anyone that has a debt or claim.[5] The types of claims creditors can have include basic debts and claims for damages, as well as contingent claims that haven't given rise to a loss yet but may in the future.

[5] *Corporations Act 2001* (Cth) s 553 provides that all debts provable in a winding up are: "(1) Subject to this Division and Division 8, in every winding up, all debts payable by, and all claims against, the company (present or future, certain or contingent, ascertained or sounding only in damages), being debts or claims the

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

An unsecured creditor is a creditor that has no security over collateral that they can call upon. This means that they have no "cover" and if a company goes into liquidation they need to wait for a dividend from the liquidator to see any return. If their debtor goes into voluntary administration, then their debt may be compromised by a deed of company arrangement that is voted on by creditors.

A security interest is a right that a secured creditor takes over collateral (i.e. the property) in return for providing a loan or other advance of value. For example, a bank will take a security interest over a property when it loans a company money to buy that property.

There are two types of security interest:

- Non-circulating security interests (such as land, plants and equipment)
- Circulating security interests (such as cash, stock and debts owed to the company)

A security interest may also refer to a charge over property, and it is the bundle of rights that a secured creditor has.

In Australia an unsecured creditor in a liquidation or voluntary administration faces dim prospects of recovery of any substantial amount. The difference between an unsecured and a secured creditor is that a secured creditor has collateral that they may call upon if their debtor goes into insolvency.

INSOLVENCY ISSUES FOR SMES

9. 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 in June 2018 there were more than 2.3 million actively trading businesses in Australia and of these:

- 542, 685 businesses had 1-4 employees (microbusinesses);
- 187, 360 businesses employed 5-19 employees (small businesses); and
- 49, 202 employed 20-199 employees (medium businesses).[6]

The smaller size of SMEs, compared to large corporations and government entities, belies the importance of this segment to the economy. SMEs accounted for 34% of Industry Value

circumstances giving rise to which occurred before the relevant date, are admissible to proof against the company."

[6] Australian Bureau of Statistics, 8165.0 - Counts of Australian Businesses, including Entries and Exits, June 2014 to June 2018.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

Added and 29% of all wages and salaries paid in selected industries of the private sector in 2017-18.[7]

The ABS also reported that in 2017-18, businesses with a turnover from $50k to less than $200k had the highest entry rate (20.6%) and businesses with less than $50k had the highest exit rate (19.4%).[8] Although "exit" does not necessarily mean all those businesses had become insolvent we can still assume that a significant proportion were insolvent or at least unviable.

97.4 percent of micro businesses are wholly Australian owned,[9] and they are more reliant upon a smaller number of customers that are members of their local community. This means that SMEs are going to be closer to their local communities and that facilitating the prosperity of SMEs will have a positive impact on local communities throughout Australia.

Small-to-medium sized businesses are therefore the backbone of the economy and local communities.

10. What financial and operational issues do SMEs face?

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

- Australia's slow paying culture by customers; and
- Poor management of SMEs.

Other issues that SMEs face that cause insolvency include:

- Poor access to finance;
- Implementing big projects that aren't properly financed or provisioned for;
- Growing too fast (overtrading);
- Timing; and
- Combining one of the above causes with a predictable risk event occurring and creative accounting.

Cause 1: Australia's poor payment culture

Australia has a culture of slow payers in business and this is exacerbated in some industries such as building and construction.

[7] Geoff Gilfillan, Small business sector contribution to the Australian economy, 7 January 2020, available at: <https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/rp1920/SmallBusinessSectorAustralianEconomy>.
[8] Australian Bureau of Statistics, 8165.0 - Counts of Australian Businesses, including Entries and Exits, June 2014 to June 2018.
[9] Australian Treasury, Australian Small Business, December 2012, available at: <www.treasury.gov.au> p. 31.

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.[10] In plain English, that means that the customers/clients of SMEs trigger insolvency by not paying their bills on time. The paper uses empirical research to show 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 it took for these debts to be paid. The results for B2B debt payments from the date an invoice was issued were:

Australia 54.1 days v NZ 43.1 days.[11]

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 both the highest proportion and number of insolvencies compared to other industries. To remedy this, construction contracts with "pay when paid" terms for payment were outlawed and subcontractor payments sped up through the Security of Payment legislation.[12]

Often the question is asked, 'what is the point of no return in the spiral to insolvency?' The answer is that there are several key indicators, including:

- Chronic insolvency
- Winding up applications
- Director Penalty Notices from the ATO
- Staff walking out the door
- Being put on stop by suppliers
- Deadlock between owners and/or management about the future of the business.

While these are all signs of a spiral towards insolvency, it is important to note that these are symptoms rather than root causes of insolvency. These symptoms will follow the causes and trying to cure the symptom will ultimately lead to frustration.

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 2: Poor management

[10] Australian Government, Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education, Australian Prompt Payment Protocol, Discussion Paper, July 2013, p. 4.
[11] Australian Government, Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education, Australian Prompt Payment Protocol, Discussion Paper, July 2013, p. 10.
[12] For example, Building and Construction Industry Security of Payment Act 1999 (NSW).

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

The bad news is that the prime cause of business failure is poor management. One definition of management is the art of “getting things done through others”.[13] Another definition by Peter Drucker defines management as a “multi-purpose organ that manages business and manages managers and manages workers and work”. The first hint from those definitions is that good management understands they don’t have the job of doing everything in a business.

There is no simple way to learn to manage a business because it is an art that is learnt through practice and experience.

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 financial 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 high-level performance expectations. Down-to-earth, direct and goal-oriented managers are likely to get the most from their staff.

Australia has recognised that it needs to encourage entrepreneurs to move past business failure. In 2016 the Federal Government announced a plan to improve the “balance” of insolvency laws to encourage entrepreneurs. This was implemented within the *Insolvency Law Reform Act 2016*. According to the Australian Financial Security Authority, the amendments aim to:

- remove unnecessary costs and increase efficiency in insolvency administrations;
- align the registration and disciplinary frameworks that apply to registered liquidators and registered trustees;
- align a range of specific rules relating to the handling of personal bankruptcies and corporate external administrations;
- enhance communication and transparency between stakeholders;
- promote market competition on price and quality;
- improve the powers available to the corporate regulator to regulate the corporate insolvency market and the ability for both regulators to communicate in relation to insolvency practitioners operating in both the personal and corporate insolvency markets; and

[13] Quote credited to Mary Parker Folett.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

- improve overall confidence in the professionalism and competence of insolvency practitioners.[14]

The good news for SME directors is that the direction of policy in Australia is to help them to learn from their experiences and continue to innovate and develop businesses after a business failure.

One area that has not been researched is whether sickness is a significant contributor to business failure in SMEs. We are almost guaranteed to be very sick at some time in our lives and a mental or physical illness will impede a director's ability to properly manage a business. In Australia there is no established 'locum' system for SME directors that can provide a person who can easily step into the shoes of a director whilst they are unwell. If directors are sick they may need to look to friends, family or employees to take over a business.

Cause 3: Poor access to finance

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 but since that time the spread has jumped to at least 2%.[15] SMEs are reported to most commonly seek finance to maintain short term cash flow or liquidity.[16]

Access to finance is a critical issue faced by SMEs and anecdotal evidence suggests that the banks are avoiding lending to SMEs overall.

Cause 4: 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. Costs and timeframes are often underestimated and/or revenue is overestimated and this may lead to insufficient working capital.

The risky 'big project' could include any one of the following:

- Taking on a larger than usual contract
- Building a side business
- Creating a new product line

[14] Australian Financial Security Authority, About the Insolvency Law Reform Act (ILRA), available at: <https://www.afsa.gov.au/about-us/agency-overview/law-reforms/about-insolvency-law-reform-act-ilra#>.

[15] Australian Treasury, Australian Small Business, December 2012, available at: <www.treasury.gov.au> p. 61.

[16] Australian Treasury, Australian Small Business, December 2012, available at: <www.treasury.gov.au> p. 34.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

- Implementing a new software system
- Outsourcing or offshoring a key function of the business
- Acquiring another business

Cause 5: Overtrading

It is obvious to point out that business growth costs money (i.e. working capital) because additional funds are required to build a business before actual income from increasing revenue is received. Overtrading is engaging in more business than can be supported by the funds or resources available to the directors.

Overtrading is another major cause of business failure. A director may set a sales target for the business that is reached but they also need to consider the working capital required to fund this growth.

If a business overtrades it may need to seek additional funds from a line of credit or a director's loan.

One form of overtrading is offering 'easy' credit to customers by way of taking on poor quality clients or granting them extended trading terms. Both of these options for building business need to be carefully considered before being undertaken.

Cause 6: Timing

Watch out for tax debt enforcement as the final straw before collapse.

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. 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 Charges (*SGC*) and unpaid PAYG contributions.

Since 2012, directors of SMEs have been held to be personally liable for PAYG and SGC contribution liabilities that are unpaid and unreported for three months. The personal liability accrues irrespective of whether the ATO issues a DPN. However, the DPN now 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.

Once the ATO commences action by way of a DPN or winding up application then the prospects of a company surviving are poor.

Cause 7: Add a predictable business risk event

If a business is already in a tight financial situation because it is overtrading, taking on a big projects, or is otherwise poorly managed, the occurrence of a predictable event may cause the business to fail.

Predictable risk events are not likely to cause a healthy business to fail but they may cause a vulnerable business to tip over. An example of this is an e-commerce website being hacked. Anyone that operates an e-commerce business will be conscious that they may be hacked one day and they may take steps to minimise that risk or even take out insurance.

Unfortunately, there is no way to prevent these normal business risks. Losing a big customer, having a key person in the business resign, an economic downturn or an act of god (e.g. weather), are other examples of predictable risk events.

The established rule of thumb is that a business should have cash at bank equal to at least 3 months of business expenses in order to be covered in the event of a predictable business risk event occurring.

Cause 8: 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 faced by a business.

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 the 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.

11. What is the legal meaning of insolvency?

Insolvency is an important concept for directors because it is a long established legal rule that when a company approaches insolvency they are under a duty to consider the interests of creditors.

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 realise their assets fast enough to satisfy their debts as they become due and payable. To be insolvent, a company must have an endemic 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 because it is a more accurate test of the viability of a company's business. 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.

A Court analysing solvency 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 that it 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 Corporations 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 reconstructed.[17]

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

Insolvency is usually worked out retrospectively in Court, so what is more useful to directors is to understand the forward indicators of insolvency. Unfortunately, this isn't an exact science but there are a number of indicators that will be looked at adversely by the Court and creditors.

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;

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

(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.

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, a new financier or an incoming investor.

Directors and advisers of SMS

13. What are the principal legal duties of directors?

Being a company director means that you assume personal legal duties. These duties cannot be delegated and the law is designed to limit the excuses for breach that directors have to avoid sanctions or paying compensation. In an insolvency scenario, a liquidator may look to enforce these claims (on behalf of the company and creditors) against the former directors.

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

<u>Common law (or fiduciary) duties</u>

- *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 powers 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,[18] or by manipulating voting power.

  Regardless of whether the improper purpose is the dominant cause 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.[19] This is eloquently called the 'but for' test.

- *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.

<u>Statutory duties under the Act</u>

- *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

  (b) occupied the office held by, and had the same responsibilities within the corporation as a director or officer.[20]

  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:

[18] *Mills v Mills* (1938) 60 CLR 150 at 185.
[19] *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.
[20] *Corporations Act 2001* (Cth) s 180(1).

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

(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.[21]

- *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.[22]

- *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.[23]

  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.[24]

- *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.[25]

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

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

  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;

[21] *Corporations Act 2001* (Cth) s 180(2).
[22] *Corporations Act 2001* (Cth) s 181(1).
[23] *Corporations Act 2001* (Cth) s 182(1).
[24] *R v Byrnes* (1995) 130 ALR 529.
[25] *Corporations Act 2001* (Cth) s 183(1).

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

(d) he or she failed to prevent the company from incurring the debt.[26]

A director may also face criminal penalties for breaching this duty if his or her failure to prevent the debt was dishonest.[27]

- *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.[28]

  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.

- *Section 588GAB – Officer's duty to prevent creditor-defeating dispositions*

  An officer of a company must not engage in conduct that results in the company making a creditor-defeating disposition of property of the company.

14. What is insolvent trading?

Directors are under a duty to prevent insolvent trading under section 588G of the Corporations Act. A claim 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 the 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 that a reasonable person in their position would be so aware.

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 that date passes the commencement of a claim is statute barred.

[26] *Corporations Act 2001* (Cth) s 588G(1) and (2).
[27] *Corporations Act 2001* (Cth) s 588G(3).
[28] *Corporations Act 2001* (Cth) s 191(1).

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

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. It is rare that a liquidator would make an insolvent trading claim because they would need to prove the insolvency of the company and this is not a simple task.

The duty to prevent insolvent trading does not apply when a director is able to claim protection under the new safe harbour from insolvent trading (section 588GA of the Corporations Act).

15. How does a director get a safe harbour protection from insolvent trading?

The new safe harbour from insolvent trading is the most significant reform in corporate insolvency since the introduction of voluntary administration in 1993. The new reform can be used in conjunction with, or implemented separately to, a pre-pack insolvency arrangement.

In September 2017 the Federal Government passed the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 which inserted a new section 588GA into the Corporations Act 2001 (Cth). The amendment gives directors the right to enter a "safe harbour" protecting them from personal liability for trading their company whilst it is insolvent.

The prohibition on insolvent trading is a very strong disincentive for directors from attempting an informal restructure or work-out because they are at risk of personal liability for trading whilst insolvent.

Requirements for safe harbour protection

Entry into the safe harbour doesn't occur automatically. Directors must comply with the requirements of the Act and will only have protection from personal liability for insolvent trading if:

- At the time they suspected or knew the company was insolvent they start developing a course of action that at the time of development was reasonably likely to lead to a better outcome for the company than proceeding to immediate administration or liquidation; and
- The debt was incurred directly or indirectly in connection with a course of action.

Companies are also required to pay all staff entitlements during this period and comply with tax reporting obligations, or they will lose the protection of the safe harbour for all debts that were incurred.

Course of action reasonably likely to lead to a better outcome

Determining whether a course of action is "reasonably likely" to lead to a better outcome will vary on a case by case basis. A course of action in this context refers to a turnaround or restructuring plan that has the objective of putting the company in a better position than it would be in a voluntary administration or liquidation scenario.

In the explanatory memorandum for the new legislation, the required standard of "reasonably likely" is a chance of achieving a better outcome that is not fanciful or remote, but is "fair", "sufficient" or "worth noting".

Section 588GA(2) outlines a non-exhaustive list of factors that are taken into account when determining whether a course of action taken by a person was reasonably likely to lead to a better outcome. These include the directors:

- Keeping themselves updated with the financial position of the company;
- Taking appropriate measures to prevent officers or employees from hindering the ability of the company to pay its debts;
- Taking appropriate measures to ensure financial records are kept;
- Obtaining advice from an "appropriately qualified entity"; and
- Implementing the restructuring plan to improve the company's financial position.

Best practice

In light of the requirements of section 588GA, the Turnaround Management Association (TMA) has published best practice guidelines to guide the safe harbour process. The flow chart of best practice can be obtained on the TMA website.

Key stages of the TMA best practice include:

- The safe harbour period will begin at the time a person starts developing a course of action, of which will include an initial financial assessment of the company when the directors suspect the company may be insolvent.
- After it is determined that the company is insolvent, the directors should engage an "appropriately qualified entity" to assess the availability of entry into the safe harbour. If they receive advice that they should enter the safe harbour, the directors should then begin to develop a turnaround or restructuring plan.
- Once the plan is developed it must be put into action. If it is not actioned within a reasonable period of time (of which is determined by the complexity of the restructure) directors will lose the benefit of the safe harbour.
- The turnaround or restructuring plan must be continually monitored so that the success or failure of the plan can be measured. It may be the case that the plan hasn't worked as intended and steps need to be taken to place the company into administration or liquidation.

Challenges for SMEs

Crucially, each stage of the process should be carefully documented so that directors can prove they have met their threshold obligations. It is this evidentiary burden that may provide a challenge for SMEs who may not have sufficient professional support to document their claim for safe harbour protection.

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

The DPN regime is a targeted instrument used by the ATO to pierce the corporate veil and make directors personally liable for company tax debts. The key mistake made by directors is non-compliance with lodgement obligations. That means if directors don't lodge their tax returns on time, they could be liable for a DPN.

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 ATO. 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 on 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 a voluntary administrator or a liquidator is appointed. If the unpaid amount was not reported within three months of the due date for lodgement, 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.

The liability for a DPN is subject to very limited defences that are unlikely to be utilised in most cases.

17. 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 Corporations Act. 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; [29]
- If a court finds a person guilty of an offence under s 588G(3) in relation to a company incurring a debt whilst insolvent, the criminal court may order compensation;[30]
- A creditor may sue for compensation;[31] and
- A director may be held liable to indemnify the Commissioner of Taxation for unpaid debts.[32]

<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."

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.

<u>Civil penalties</u>

The 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

[29] *Corporations Act 2001* (Cth) s 588J.
[30] *Corporations Act 2001* (Cth) s 588K.
[31] *Corporations Act 2001* (Cth) s 588R and 588T.
[32] *Corporations Act 2001* (Cth) s 588FGA.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

compensation. The Court may also order, on application by the ASIC, to disqualify a director from managing corporations.[33]

Under division 4 of the Act, a director is liable to compensate the company for loss resulting from insolvent trading.[34] 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.[35]
- A creditor may recover from the director an amount equal to the loss or damage caused by the breach.[36]
- If the breach is proven to be a result of the director's dishonesty, the director may be found guilty of a criminal offence, punishable by a fine or imprisonment.[37]

The new creditor-defeating disposition reforms introduce criminal and civil penalties for individuals and corporate bodies that contravene the duties outlined above. To be held criminally liable the individual or body must have been reckless as to the result of their conduct and to be held civilly liable the individual or body must have been unreasonable in their conduct. If such a standard is proven, hefty penalties can be enforced by the court including fines of up to 4 500 penalty units for individuals and 45 000 penalty units for corporations. Individuals can also be imprisoned for up to 10 years and corporations can be fined up to 10% of their annual turnover.

18. 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 director's first steps should be:

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

Seek or advance more working capital

Given there is an endemic shortage of working capital, cash is king! The first step may be to seek or advance further working capital for the business, however, in the long term, this does not solve the problem if the business has a loss making business model.

[33] *Corporations Act 2001* (Cth) s 206C.

[34] *Corporations Act 2001* (Cth) s 588M.

[35] *Corporations Act 2001* (Cth) s 588M and 588K.

[36] *Corporations Act 2001* (Cth) s 588M.

[37] *Corporations Act 2001* (Cth) s 588G(3) and Schedule 3.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

Immediate options are:

- 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, it is unlikely that there will be an alignment of interests and your lenders are unlikely to be able to assess the risks of lending to you. This may put pressure on your relationships 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.

If directors advance money themselves they should consider whether they can obtain a security interest over business assets. If directors advance monies out of their own pocket without security they will become unsecured creditors in the event of company failure unless they obtain a security interest.

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, and 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 the 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.

19. 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 advisers without having one particular co-ordinating adviser. A consensus model for professional advisers would be sure to fail in a turnaround scenario.

It is likely that a lawyer, financial accountant and insolvency practitioner with different briefs will pull in opposite directions. Each professional will 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, and/or supervision of, pre-pack insolvency arrangements. These are:

- Small firm accountants
- Insolvency practitioners
- Lawyers
- Pre-insolvency advisers

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 they are a sole practitioner.

Small firm accountants 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 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 to 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 Corporations 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.

It is also unlikely that general accountants 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 insolvency arrangement because they do not have the specialist insolvency knowledge necessary.

Another issue with a small practice accountant is time. They are likely to have over 100 ongoing clients and will need to juggle their other clients with a turnaround client. It is unlikely that they will have the time to “drop everything” and work on a turnaround.

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). However, it is not essential that registered liquidators be members of ARITA.

Insolvency practitioners are qualified to provide advice, and assist in the set-up, or supervision of a pre-pack insolvency arrangement. Insolvency practitioners are likely to have a thorough and up-to-date understanding of insolvency law and practice that they have developed through education and day-to-day work on company liquidations and voluntary 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, but if they fail to obtain this approval from creditors, the insolvency practitioner can apply to a 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 supervise a pre-pack insolvency 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.[38] Insolvency practitioners are also required to refuse appointments where they have had a professional relationship with the insolvent company within the previous two years.[39] As a result of these conflict rules, insolvency practitioners are disqualified from 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 insolvency arrangement may undermine an insolvency practitioner's impartiality.

There is also a larger issue to be considered by a company director about a conflict of interest. If an insolvency practitioner advocates for a pre-pack insolvency arrangement, they may only receive a fraction of the fees that they could have generated from a voluntary administration. Therefore, there is a risk that due to this conflict of interest, insolvency practitioners may steer directors towards voluntary administration rather than a less expensive pre-pack insolvency arrangement.

Lawyers

Specialist insolvency lawyers can advise regarding the legality of a pre-pack insolvency 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".[40] Most tasks in the preparation of a pre-pack arrangement relate to

[38] ARITA Code of Professional Practice for Insolvency Practitioners Rule 6.8.1(B).
[39] ARITA Code of Professional Practice for Insolvency Practitioners Rule 6.8.
[40] *Legal Profession Uniform Law* (NSW) s 6.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

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).

On the other hand, it may be essential to have a lawyer draft a business sale or asset sale contract. A pre-pack insolvency arrangement may be clawed back if a Court finds it is uncommercial, a sham transaction or a creditor-defeating disposition.

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-basis).

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

Pre-insolvency advisors are not registered with the 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 inadequate training and lack of insolvency experience, pre-insolvency advisors often have no explainable methodology for company restructuring. At the lowest end of the market these consultant’s stock-in-trade is helping directors to illegally hide assets and engage in phoenix activity.

However, if a pre-insolvency advisor has industry-specific knowledge built up from experience, they may be useful. Directors should test the knowledge and qualifications of pre-insolvency advisers before engaging them to lead a turnaround.

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

The most significant advisory duty stems from the creditor-defeating disposition reforms. Under section 588GAC of the Corporations Act, a person must not engage in conduct of procuring, inciting, inducing or encouraging the making by a company of a disposition of property that results in the company making the disposition of the property.

The key takeaway here is that liability now extends to other persons who facilitate a company making a creditor-defeating disposition, including professional advisers such as solicitors. However, there are no court cases that provide examples for the enforcement of this law against professional advisers at the date of this whitepaper.

In addition, advisors are obliged to comply with the Corporations Act. In particular, section 79 of the Corporations Act provides that a person is involved in a contravention of the Act if they:

(a) aided, abetted, counselled or procured a contravention; or

(b) induced, whether by threats or promises or otherwise, the contravention; or

(c) have been knowingly concerned in a contravention; or

(d) have conspired with others in a contravention.

This means that professional advisers have accessorial liability for breaches of director's duties by their clients where they have aided the client. A good example of a professional adviser being prosecuted for breaching their duties in providing professional advice advancing phoenix activity is the Somerville case.

<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. That is, phoenix activity, by another name.

In that case, Mr Somerville advised a number of directors of companies in financial difficulty. His advice was to restructure each of the companies by using the following methodology:

1. The old company ceased to trade;
2. A new company was established;
3. The old company sold its assets to the new company on the following terms:
    a. Assets transferred from old company to new company;
    b. New company issued 100 "V" class shares to the old company as consideration;
    c. Employees of the old company were terminated and offered employment with the new company;
    d. New company took over plant, equipment and leases;
    e. Debts and liabilities remained with the old company.

The Court found that the assets were transferred to the new company for illusory consideration and that the transaction was therefore a sham (i.e. the grant of discretionary "V" class shares was found to be unsatisfactory consideration).

The result was that the Court found that Mr Somerville had breached section 79 of the Corporations Act 2001.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

In addition to the Corporations Act, professional advisers have fiduciary obligations to their clients. This means that all professional advisers are required to:

- Act honestly and fairly in their client's best interests;
- Act with due skill and diligence;
- Maintain a client's confidences;
- Avoid conflicts of interest; and
- Follow a client's lawful instructions.

The fiduciary relationship will be particularly relevant where a professional advisor is engaged by an "Oldco" because it will be necessary to identify a satisfactory commercial benefit to Oldco for entering into any asset sale transaction as part of a pre-pack insolvency arrangement. If a professional adviser is in breach of their fiduciary duties they may be liable to Oldco's subsequently appointed liquidator to pay compensation.

Solicitors also need to comply with the provisions of their state based professional conduct rules. These rules largely replicate the solicitor's duties as a fiduciary and require the solicitor to act in the best interests of their client. Failure to comply with professional conduct rules can lead to a solicitor being found to be unfit to practice and subsequently struck off. This is seen as a severe remedy and it is not regularly applied. As an example, Mr Somerville was not removed from the list of solicitors following the judgment in *ASIC v Somerville* despite being found to be knowingly involved in phoenix activity.

Accountants providing advice to an insolvent SME need to comply with the professional rules of the CPA or CA. The APES 110 Code of Ethics for Professional Accountants, followed by CPAs and CAs, requires members to act with integrity, objectivity, professional competence, and due care, and to comply with all relevant laws. Failure to comply with these rules can lead to sanction from the accountants professional body where applicable.

LIQUIDATORS OF SMES

21. Who are liquidators and what do they do?

A liquidator is a natural person who is registered with ASIC as a liquidator and who is authorised to be a liquidator and voluntary administrator of a company. A liquidator can be appointed by either a creditor (through a Court application) or by members of the company.

Registered liquidators act in a fiduciary capacity and have total management control of the affairs of a company once appointed as liquidator. This means they are under a legal duty to be independent, impartial and honest. When a company is in liquidation due to its insolvency, the liquidator has a duty to all of the company's creditors.

The general purpose of a liquidation is to close a company's business because it has no realistic chance of resolving its financial difficulties.

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.

The liquidator must investigate the financial affairs of the company and it is a primary purpose that these investigations 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 antecedent transactions can be clawed back for the benefit of creditors.

A liquidator has the following functions:

- 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[41] or unfair preferences;[42]
- Conduct investigations as to whether there may be any causes of action against directors for insolvent trading or other breaches 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 Corporations Act and, more specifically, acting in the interests of creditors.

Any undertaking given by liquidators before their appointment is unenforceable at law. This is relevant for any directors that have complaints about the conduct of a liquidator. In short, liquidators (as agents of the company) owe duties to the company itself and its creditors but not directly to their appointors (if directors).

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

If company goes into liquidation, the liquidator is under an obligation to sell the assets of the company. Their legal obligation in the sale process isn't significant because they are only under an obligation to sell the assets for the best price reasonably obtainable at the time of sale. That means any sale process is likely to be hurried: essentially, a fire sale.

[41] *Corporations Act 2001* (Cth) s 588FB.

[42] *Corporations Act 2001* (Cth) s 588FA.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

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 earnings 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.[43] Liquidators would also be likely to seek the approval of a committee of creditors before taking a risk and trading on 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.

[43] *Corporations Act 2001* (Cth) s 477(1)(a).

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

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 useful to point out that a liquidator has no “skin in the game” in the sale process.

A liquidator is remunerated 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. Most of a liquidator’s fees will be generated by having junior staff conduct due diligence, deal with various stakeholders and otherwise “tick boxes”. Ultimately, the longer the liquidator delays the sale process, the longer it will take to realise the bulk of their professional fees.

This may be described as an agency problem. The Australian insolvency system (unlike the United States and Chapter 11 of their Bankruptcy Code) 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 "bidder's 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.

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

If directors engage in transactions that are illegal before their company goes into liquidation they may face litigation by the liquidator. If directors are contemplating an asset transfer before liquidation it is essential that they consider liquidator claw back actions before undertaking the transaction. If they do not, they may be accused of phoenix activity if the transaction is illegal or poorly thought out. The key risk is that a pre-pack insolvency arrangement could be found to be an uncommercial transaction by a Court.

A liquidator may seek to claw back transactions if they were made or entered into by a company in liquidation, immediately preceding the company's liquidation on the basis that the transaction was an insolvent transaction.

Liquidators have various powers under the *Corporations Act 2001* (Cth) (*the Act*) to claw back assets and payment transfers that occurred in the time period immediately before the company went into liquidation. The rationale for the powers are driven by a desire to treat creditors equally, i.e. *pari passu.*

A liquidator may commence action against a related entity or other creditor under section 588FF of the Act. Under section 588FF the courts are delegated the power to make orders about voidable transactions.

Voidable transactions include the following:

- *Unfair preference payments*
  Under section 588FA of the Corporations 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.

An unfair preference claim may result if a director repays their loan account (unsecured) in the six month period before liquidation.

- *Uncommercial transactions*
  Under section 588FB of the Corporations 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

  d) any other relevant matter.

  An uncommercial transaction claim may result if a director transfers business assets to themselves for a value that is below the market price before liquidation.

- *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) the 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.

An unreasonable director-related transaction claim may result if the director arranges for value to be moved from the company in liquidation to a family member. The test is not what is commercial but rather what is "reasonable". This means that the transaction may be clawed back if it is undocumented or opaque. This risk could be remedied by a thought out asset sale agreement supporting any transaction of value pre-liquidation.

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.

Finally, liquidators have the power to claw back creditor-defeating dispositions by suing both the director and any professional advisor. Creditor-defeating dispositions have been introduced to give liquidators another arrow in their quiver. If a creditor-defeating disposition has occurred, and that disposition is determined by a court to be voidable, a range of remedies will be available to creditors and liquidators. The primary remedy is the recovery of the property that has been transferred, which intends to restore the liquidator to the position they would have been in but for the disposition (ie. return of the property or physical compensation).

Liquidators make a request under s 588FGAA that ASIC make an administrative order stating that the property involved in a creditor-defeating disposition be returned, that the amount representing the benefit be paid or that an amount that 'fairly represents' the proceeds be paid. Any failure to comply with the order, is an offence which carries a fine of up to 30 penalty units or imprisonment of up to six months, or both. There are no examples of this being used at the date of writing but this is more efficient for liquidators compared to a court application.

24. What factors do liquidators take into account when they decide whether to pursue illegal phoenix activity?

Liquidators are the front line of legal action against phoenix activity. They are accountants in private practice and the key limitation on their scope of action is financial. If they are not paid, no one can force them to undertake investigations or legal action against alleged phoenix activity.

The main criticism of the regulation of phoenix activity is that there is no meaningful action by a regulator. The phoenix research team is damning in a submission to Treasury in October of 2017:

"It makes no difference which regulator hosts the hotline. Every regulator website, press release, or other publication should have clear, prominent and, above all, consistent instructions on reporting illegal phoenix activity. The important thing is that the information, once gathered, is passed on to the regulator most interested in the breach who will act in response".[44]

The Federal Government has not shown any appetite for the nationalisation of action and therefore the job is likely to principally remain with liquidators.

The key elements of a liquidator's decision to take legal action to challenge phoenix activity are set out below:

Key element 1: Cash at bank or a funder

Liquidators run a business and therefore their principal objective is getting paid. Most liquidations are assetless and therefore there are no funds available to pay legal or accounting fees to move ahead with claims.

The alternative, if a liquidator is assetless, is to seek funding from a creditor or a litigation funder. The game changer in the insolvency industry is that in the last decade the Australian Tax Office, Department of Employment (FEG) and litigation funders have been more active. Having said that, they aren't likely to be interested in claims that aren't significant. What "significant" means is changing over time, but it is likely to be in the multiples of millions.

Key element 2: Books and records availability

Access to books and records is likely to be critical or the liquidator may not be confident enough to commence the case. In the insolvency industry, evidence is essential before any litigation is contemplated.

Key element 3: Quantum of the claim

Liquidators charge high hourly rates and if they run litigation they usually won't start a case for a low quantum (i.e. the compensation claim amount).

Key element 4: Capacity of defendants to pay

Before anyone commences litigation they will want to know if the potential defendant has the capacity to pay a judgment in full. The liquidator won't have access to private information that may be useful such as ownership of ASX shares, investment account balances or bank balances but they will have access to RP data. The liquidator will undertake a property

[44] Combatting Illegal Phoenixing (September 2017) Submission by Professor Helen Anderson, Professor Ian Ramsay and Mr Jasper Hedges, Melbourne Law School, and Professor Michelle Welsh, Monash Business School, Monash University.

search and see if the director owns real property and if so where. This will heavily influence the decision to commence litigation by a liquidator.

Key element 6: Work load of insolvency practitioner

A liquidator's work on an individual company is a bit like a garden. If they don't have the time it won't be taken care of and over time doing anything may become unmanageable. The result is that often good claims sit on the shelf and are never commenced. If a liquidator has a bigger appointment or a large litigation matter they may never start a case.

Key element 7: Legal advice regarding a cause of action

Once all of the above elements are satisfied a liquidator may then compile a brief and seek legal advice. A liquidator is unlikely to commence legal action without legal advice on the prospects of success.

VOLUNTARY ADMINISTRATORS OF SMES

25. What is voluntary administration?

The directors of an insolvent company can appoint a voluntary administrator to take over the company and whilst the company is in voluntary administration, creditors cannot generally enforce their claims.

If a voluntary administration is successful, the directors will have persuaded creditors to accept a "haircut" on their debt claims and have their control of the company restored through a deed of company arrangement. A "haircut" occurs when a creditor agrees to accept less than full payment of their debt.

The voluntary administrator is required to be a company liquidator and whilst the company is in voluntary administration, they are in control of the company.

Background: The purpose of voluntary administration

The voluntary administration regime was introduced into the Corporations Law in 1993 to provide an alternative to liquidation and the immediate closure of insolvent businesses. It was intended that voluntary administration would protect the going-concern value of insolvent businesses by creating a flexible process to implement a compromise with creditors with minimal Court involvement.

The process of voluntary administration is controlled by an independent insolvency practitioner who is appointed by the directors.

If a compromise offered (in the form of a deed of company arrangement) by the directors is not accepted by a vote of the creditors, then the company goes into liquidation nevertheless.

Summary of voluntary administration

- Initiation of voluntary administration: By directors of the insolvent company (or a financier)
- Appointment criteria: Insolvency of company
- Control: The voluntary administrator assumes control and the powers of the directors are suspended
- Timeline: Usually 6 weeks in total
- Success: Occurs when the creditors vote in favour of a deed of company arrangement proposal and the business of the company survives
- Failure: The creditors and the voluntary administrator oppose the compromise offered and the assets of the company are sold in a fire-sale after liquidation

Typical reactions of key suppliers, employees and other stakeholders

- By industry: Some industries have stakeholders that react aggressively to the voluntary administration process, such as building and construction
- Landlords: Rarely compromise on rent that is overdue and this may result in a lock-out from trading premises after a voluntary administration commences
- Sub-contractors: Will not expect a return from a deed of company arrangement and will therefore be likely to react aggressively
- Employees: It is a requirement that they are paid in full but they are unlikely to enjoy being managed by the voluntary administrator

Deed of company arrangement proposal terms

The terms of the director's offer of compromise are put to creditors by the voluntary administrator in a report along with a recommendation. Whether the voluntary administrator recommends that creditors accept the proposal is a matter for their professional judgment. The vote requires both a majority in number and a majority in value of the creditors to support the proposal for it to succeed.

The proposal terms should be prepared in advance of the appointment and considered before a voluntary administrator is appointed. Directors should consider whether they can afford the price offered and whether the business itself is sustainable.

Pre-pack insolvency arrangement versus voluntary administration

The two key characteristics of an insolvent company that may be more suitable for a pre-pack insolvency arrangement (compared to a voluntary administration) are:

- That there is a serious risk the goodwill in a business will be damaged by a formal appointment scenario; and
- The costs of a voluntary administration are uncommercial.

The benefits of a pre-pack insolvency arrangement are that directors maintain control of the sale process and can forward plan costings before executing a plan. Australian insolvency law does not allow for directors to have control once an external administration is commenced and strict independence standards apply. Any pre-appointment sale of the business prior to the liquidation of the Oldco will, at law and practically, be subject to review by the liquidator.

Consequences of failure and the liquidation of the company

If there is a vote by creditors against the deed of company arrangement proposed by the directors then the company will be placed in liquidation at the conclusion of the meeting. The liquidation will result in the fire sale of any assets of the company unless an offer is put to purchase the assets that is satisfactory to the liquidator.

26. 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. It is also a reasonable hypothesis to suggest that in over 90% of cases voluntary administration does not deliver what was initially sought by directors.

A 1998 Australian Securities Commission (*ASC*) research paper reported the outcomes of empirical research into the reasons why directors appointed a voluntary administrator.[45] 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 the 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.

[45] ASC Research Paper 98/01, A study of voluntary administrations in NSW, Australian Securities Commission, Sydney, 1998, pp. 26-27.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

- To facilitate a liquidation (20%). This may be part of a strategy to delay liquidation and, for example, it 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.

An 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 for commencing the voluntary administration process.[46] 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;
- 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 the relation back period if a winding up application is filed.

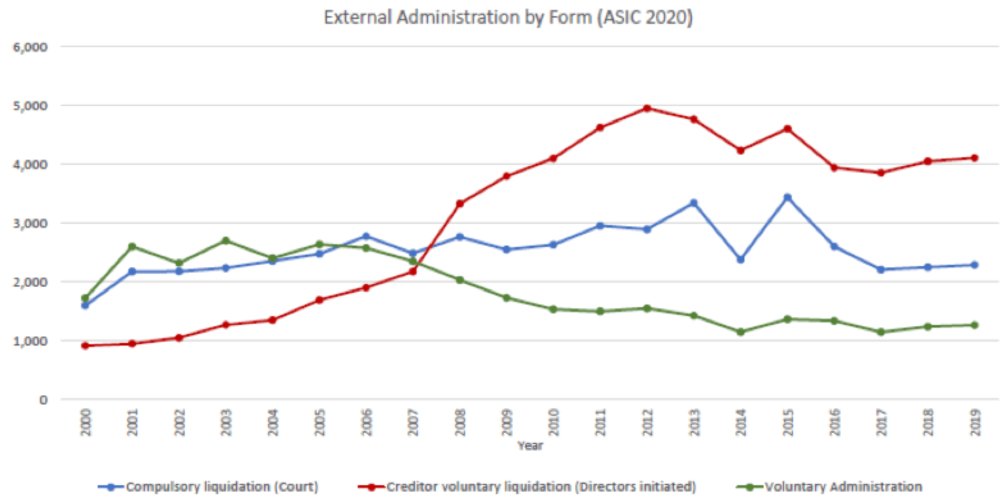
The above is a list of the challenges that the voluntary administration regime may tactically deliver. From an insolvency lawyer's point of view, there is a critical difference between motivations that are against policy and motivations that are illegal. There is no suggestion that the above motivations 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, as it may fail to deliver a debt free business with harmonious employee and supplier relationships after it has been completed.

It should be noted that over the last 20 years, the popularity of voluntary administration has deteriorated sharply.

---

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

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001



The above chart shows the inversion of the use of voluntary liquidation by directors (Creditors Voluntary Liquidations or 'CVLs'), and voluntary administration over the last 20 years. What has caused this? The likely contributors include:

- phoenix activity – the often illegal practice of transferring business assets into a new company for less-than-market consideration;
- high failure rates of failure of voluntary administration; and
- the streamlining of CVL appointments by directors.

The unfortunate reality is that many professional advisers appear to have given up on voluntary administration as a useful mechanism for formal restructuring of SMEs. Aside from the reputational effects of going into voluntary administration in Australia, creditors are aware that they are unlikely to get a return so will often use their power to vote down a restructure (i.e. they are 'out of the money').

27. What is the downside of voluntary administration?

The main criticism of voluntary administration, overall, is that it is no longer capable of regularly delivering the compromise between creditors and company directors that it was intended to produce.

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 unpredictability.

High 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 but 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 (s 439A);
c) Conducting the first meeting of creditors (s 436E);
d) Dealing with creditor's enquiries (s 437A);
e) Investigating the affairs of the company and forming an opinion on the best course of action for the company (s 438A);
f) Preliminary investigations into whether there are any transactions that would be voidable transactions in a liquidation (r 5.3A.02 *Corporations Regulations 2001);*
g) Reporting any suspected misconduct by directors to ASIC (s 438D);
h) Preparing and issuing a detailed report to creditors (s 439A);
i) Conducting the second meeting of creditors (s 439A, s 439B); 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.[47]

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

The economic justification for high pricing is the personal trading risk administrators assume (because they pay for any shortfalls in trading receipts) and that some appointments taken do not sufficiently pay their fees. To compensate the voluntary administrators for a personally risky job, they charge heavily. There is also a view (derived from largely

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

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

anecdotal evidence) that insolvency practitioners are too numerous, or alternatively, that there are too few jobs to support them.

A public process is initiated

Within three days of taking an appointment, administrators are required to publish a notice of their appointment as administrator of the company.[48] This means that all creditors, as well as the public, will become aware that the business is insolvent and this will reduce the chance of the business being 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 companies' paper suppliers combined to refuse to supply any stock to the administrators and they were forced to close the business.

The directors lose control of the company

Sections 437A and 437C of the Corporations 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 are prohibited from acting 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.

There are often undertakings or understandings regarding how an administrator will conduct business. Any such undertakings are unenforceable at law and, further, there is no guarantee that the business will continue to trade and not be closed. Whether the business continues trading is a judgment call of the administrator that cannot be reviewed by the directors or appealed in Court.

The process of voluntary administration involves two meetings of creditors, required by sections 436E and 439A of the Corporations 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's 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 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.

[48] *Corporations Act 2001* (Cth) s 450A.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

Black Swan events

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, and then suppliers and customers are informed of the company's insolvency and invited to vote and decide upon the future of the company. At this stage employees are also given a strong signal that the future prospects of the company are limited.

The typical outcome of a voluntary administration may be described as a "glorified liquidation".[49] The voluntary administration process is subject to a vote of creditors at the second meeting of creditors that decides the fate of the company (i.e. liquidation or deed of company arrangement). Most voluntary administrations today result in a liquidation rather than a DOCA.

In a voluntary administration scenario, the mixture of conflicting interests means that unpredictable outcomes are foreseeable but not precisely predictable.

What would an exceptional outcome of a voluntary administration look like?

The purpose of voluntary administration is to deliver a compromise between directors and creditors. An exceptional outcome to a voluntary administration would include the following:

- Trading on the business through a DOCA and beyond
- Third party contribution to the DOCA fund
- Arrangements with continuing creditors to ensure ongoing support outside the DOCA
- Motivated management and staff (good culture)
- Some return for non-continuing creditors (e.g. 10c in a dollar)

There is no empirical research in Australia that comprehensively explores the incidence of this 'exceptional outcome' for a voluntary administration. The writer estimates that this would occur in less than 5% of voluntary administrations. It would be fair to conclude that any appointment of voluntary administrators would receive a hostile reception in Australia and a positive outcome is extremely unlikely.

28. 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:

[49] Mark Norman Wellard (2014) A sample review of Deeds of Company Arrangement under Part 5.3A of the Corporations Act. ARITA Terry Taylor Scholarship. Australian Restructuring Insolvency and Turnaround Association, available at: <https://eprints.qut.edu.au/74002/>.

- 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 of 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 compromise 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 debt shortfalls 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, therefore 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 by creditors and therefore any pre-appointment undertaking for a low cost voluntary administration 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.

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

When considering a pre-pack insolvency arrangement the question of practitioner independence may arise. Under Australian Law, insolvency practitioners are not permitted to have “substantial prior involvement” with a company to which they are later appointed.

Therefore, if an insolvency practitioner is involved in a pre-pack insolvency arrangement before a formal appointment and then takes the appointment as voluntary administrator, they will be in breach of their duties.

When conducting a sale of a company’s assets, an insolvency practitioner appointed has a duty to obtain market value. If the market value is unattainable they are under a duty to obtain the best price obtainable for the company and its assets at the time of sale.

ARITA code

The ARITA Code of Professional Practice stipulates that when accepting or retaining an appointment, the practitioner must at all times during the administration be, and be seen to be, independent. An insolvency practitioner must be independent in fact, and be seen to be independent to the people outside of the immediate appointment.

The ARTIA code specifies that a practitioner must be seen to be independent, meaning they must not accept an appointment or continue to act under an existing appointment, if:

- A reasonable and informed third party;
- On the information available (or which should have been available) at the time;
- Might reasonably form the opinion that the practitioner might not bring an independent mind to the administration and thus may not be impartial or may in fact act with bias;
- Because of a lack of independence, or perception of a lack of independence.

Conflict of independence

Under the ARITA Code the mere possibility of a conflict does not mean the practitioner must refuse or cease appointment. The test lies in whether a reasonable and informed third party on the information reasonably available at the time, could have formed the view that the conflict was likely to arise.

The Code generally states that practitioners must not take an appointment if they have had a professional relationship with the insolvent company during the previous two years. A number of exceptions have been allowed in relation to the two year rule, where the appointment may be in the best interests of the creditors, or the relationship between the company and the practitioner was of such a nature as to have no material bearing on the independence of the practitioner.

30. What are the future prospects of voluntary administration, are results improving or declining?

The aim of voluntary administration is to maximise the chances of an insolvent company or its business remaining in existence. The aims are largely achieved through the process of a director compromise being offered and then executed through a deed of company arrangement *(DOCA)*.

There have been very few empirical reports into voluntary administration and DOCAs undertaken by academics, so it is not possible to look at the value of voluntary administration to the economy or to SME directors specifically. Whatever empirical research that has been completed needs to be interpreted and weighed up with anecdotal evidence.

One initial empirical research report in 2009 found that a quarter of voluntary administrators recommended that creditors support the director's DOCA proposals, but the average return to unsecured creditors by DOCAs were 10.3%.[50] A further empirical report completed in 2014 found that the typical returns of DOCAs for non-employee unsecured creditors were now in the order of 5-8c in the dollar.[51] This is evidence that the returns to unsecured creditors of the voluntary administration process are deteriorating.

The Wellard (2014) empirical report found that the average professional costs of a voluntary administration was $54,670 and the average deed administrator's costs were $97,141. The report also found that 72% of DOCAs were in fact "quasi liquidations".

The characteristics of quasi-liquidation DOCAs that Wellard found were:

• Composition by way of compromise;

• Business usually not traded on through/under DOCA (or only very limited, 'wind-down' trading);

[50] Herzberg, Bender & Gordon-Brown (2009) Characteristics of companies in voluntary administration: An empirical review (Conference paper published online).

[51] Mark Norman Wellard (2014) A sample review of Deeds of Company Arrangement under Part 5.3A of the Corporations Act ARITA Terry Taylor Scholarship, Australian Restructuring Insolvency and Turnaround Association.

Level 2, 255 Castlereagh Street, Sydney NSW 2000
Level 25, 600 Bourke Street, Melbourne VIC 3000
Phone: 1300 996 001

• Returns from asset/property realisations improved, enhanced or augmented by 3rd party contributions and/or exclusion of related party claims (not otherwise forthcoming in liquidation);

• Liquidation averted (in exchange for improved or more certain return under DOCA);

• No business rescue;

• Company may still remain registered;

• 3.6 cents to 6.6 cents in the dollar weighted average dividend return (depending on outliers).

One insolvency practitioner made an argument in 2014 that the result of the following statistics about the uptake of voluntary administration was poor:

"It is possible to put together a variety of statistics from ASIC and a number of research papers undertaken by the insolvency practitioners' professional body, ARITA, to determine the success rate. It's not good news:

- *15% of corporate insolvencies are voluntary administrations;*
- *33% of voluntary administrations result in a DOCA;*
- *28% of DOCAs have some sort of "creative outcome", such as saving the business."*[52]

Mr Sanderson concluded in his research that voluntary administration only saved 2% of insolvent businesses.

The empirical report above shows that the creditor outcomes, quality of DOCAs and the uptake of voluntary administrations have been deteriorating over time.

The UK has introduced the Corporate Insolvency and Governance Act in an attempt to counteract this trend. The new reforms amend the rules relating to statutory demands and winding up petitions, create a new corporate moratorium, create a new restructuring plan and place a prohibition on insolvency termination clauses.[53] A fundamental change to voluntary administration is that the role of the administrator changes to a 'monitor'. Changes to the voluntary administration process in the UK reflect the fact that the process has had poor returns in the UK, and it may be likely that in the future Australia could follow their lead.

RESTRUCTURING OF SMES

31. What is informal restructuring?

An informal restructuring is a confidential process for turning around financial results, renegotiating contracts and changing the legal structure of a business. It could also be called

[52] Cliff Sanderson (2014) Using a voluntary administration to save a company – the statistics are against you, available at: <www.smartcompany.com.au>.

[53] Alison Hardy, Chloe Meredith, Inga West and Samantha Ross, 2 July 2020, The Corporate Insolvency and Governance Act 2020: A real estate focused overview, Ashurst, available at: <https://www.ashurst.com/en/news-and-insights/legal-updates/corporate-insolvency-and-government-bill/

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

a "workout" and it could involve refinancing, changes to operations, crisis management and the termination of contracts (including employees). An informal restructure could utilise the safe harbour from insolvent trading in the event that the company was insolvent. There is no universally accepted definition of what an informal restructuring is and it is not defined in the Corporations Act 2001.

Keay's Insolvency (Tenth Edition) provides the following definitions (page 883):

Workout refers to an informal agreement between a debtor and one or more of its major creditors which alters the terms of their contractual payment arrangements to allow the debtor to improve its financial position…

A restructuring may involve the implementation of a workout proposal, in which case it is usually referred to as a balance sheet restructuring…

An informal restructuring is the opposite of a formal restructure. A formal restructure utilises the provisions of the Corporations Act 2001 to restructure through the appointment of voluntary administrators, liquidators and receivers. Alternatively, for large enterprises a scheme of arrangement may be utilised. A restructuring may be informal not in the sense that it is unenforceable at law or through contracts but rather that the mechanism used is not referred to or set out in the Corporations Act 2001.

An informal restructuring process for an insolvent company may commence with the initiation of a safe harbour protection from insolvent trading under section 588GA of the Corporations Act 2001. The directors would need to "start to develop a course of action" to turn around the business. If the business is not insolvent this is not required.

The key benefit of an informal restructure is that the process is confidential and this may be essential in an industry that is sensitive to insolvency (such as building and construction). If the business's customers, employees and creditors were aware of insolvency their sensitive reactions may result in the collapse of the business.

The techniques that may be used in an informal restructure include:

- Obtain further debt or equity funding for the business
- Terminate non-performing customer contracts and employees
- Renegotiate supplier contracts including seeking extended payment terms
- Make operational changes to the business to make it more efficient (including downsizing)

SMEs that have bank finance need to negotiate with their secured financier first. This is because their bank may have a full suite of securities including receivables, general (all present and after-acquired property), home mortgages and personal guarantees. If the directors were to restructure without the consent of their financier they may be in breach of covenants and it could result in them literally losing their homes (through the enforcement of home mortgages and personal guarantees).

The largest creditor that an SME has may be the Australian Taxation Office and it may be prepared to enter into a payment plan with the company. A payment plan would "extend terms" of tax payment but would not result in a reduction in the amount of the tax debt owed. The ATO policy regarding the tax debt and the SMEs circumstances may need to be carefully examined.

An informal restructure is different from a pre-pack insolvency arrangement because it does not utilise the sale of business assets to a related party. A pre-pack insolvency arrangement may not be able to be used, however, if there is a licencing regime in place that limits business transfer or when the main creditor is a secured creditor with security over all of the owner's personal and corporate property.

One risk of an informal restructure is that there may be a "holdout creditor". A holdout creditor may refuse to compromise their position regarding payment terms and utilise court winding up proceedings (via a creditor's statutory demand for payment of debt). The result could be that a holdout creditor wrecks a carefully crafted informal restructure when other stakeholders have agreed to a haircut. Ultimately an informal workout would rely upon consent from creditors to be successful.

32. How does a director obtain safe harbour protection from insolvent trading?

The new safe harbour from insolvent trading is the most significant reform in corporate insolvency since the introduction of voluntary administration in 1993. The new reform can be used in conjunction with or implemented separately to a pre-pack insolvency arrangement. It is the only exception to the prohibition on continuing to trade whilst a company is insolvent.

In September 2017 the Federal Government passed the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 and this law inserted a new section 588GA into the Corporations Act 2001. The amendment gives directors the right to continue to trade whilst a company is insolvent if they meet the criteria set out in that provision.

The prohibition on insolvent trading is a very strong disincentive for directors from attempting an informal restructure or work-out because they are at risk of personal liability for trading whilst insolvent. It actually makes insolvent trading illegal.

Requirements for safe harbour protection

Entry into the safe harbour doesn't occur automatically. Directors must comply with the requirements of the Corporations Act and they will only have protection from personal liability for insolvent trading if:

- At the time they suspected or knew the company was insolvent, they start developing a course of action that was reasonably likely to lead to a better outcome for the company than proceeding to immediate voluntary administration or liquidation; and
- Any trading debt was incurred directly or indirectly in connection with a course of action.

Companies are also required to pay all staff entitlements during this period and comply with tax reporting obligations, otherwise they will lose the protection of the safe harbour for all debts that were incurred. Payment of all staff entitlements is likely to be the key hurdle for obtaining safe harbour protection.

Course of action reasonably likely to lead to a better outcome

Determining whether a course of action is “reasonably likely” to lead to a better outcome will vary on a case by case basis. A course of action in this context refers to a turnaround or restructuring plan that has an objective of putting the company in a better position than it would be in a voluntary administration or liquidation scenario.

In the explanatory memorandum for the new legislation the required standard of “reasonably likely” is a chance of achieving a better outcome that is not fanciful or remote, but is “fair”, sufficient” or “worth noting”.

Section 588GA(2) of the Corporations Act outlines a non-exhaustive list of factors that are taken into account when determining whether a course of action taken by a person was reasonably likely to lead to a better outcome. These include the directors:

- Keeping themselves updated with the financial position of the company;
- Taking appropriate measures to prevent officers or employees from hindering the ability of the company to pay its debts;
- Taking appropriate measures to ensure financial records are kept;
- Obtaining advice from an “appropriately qualified entity”; and
- Implementing the restructuring plan to improve the company’s financial position.

The key take-away is that a formal written plan is not an essential element to obtain the safe harbour, although it probably should be.

Best practice

In light of the requirements of section 588GA, the Turnaround Management Association (TMA) has published best practice guidelines to guide the safe harbour process. The flow chart of best practice can be obtained on the TMA website.

Key stages of the TMA best practice include:

- The safe harbour period will begin at the time a person starts developing a course of action, of which will include an initial financial assessment of the company when the directors suspect the company may be insolvent.
- After it is determined that the company is insolvent, the directors should engage an “appropriately qualified entity” to assess the availability of entry into the safe harbour. If they receive advice that they should enter the safe harbour, the directors should then begin to develop a turnaround or restructuring plan.
- Once the plan is developed it must be put into action. If it is not actioned within a reasonable period of time (which is determined by the complexity of the restructure) directors will lose the benefit of the safe harbour.

- The turnaround or restructuring plan must be continually monitored so that the success or failure of the plan can be measured. It may be the case that the plan hasn't worked as intended and steps need to be taken to place the company into administration or liquidation.

Challenges for SMEs

Crucially, each stage of the process should be carefully documented so that directors can prove that they have met their threshold obligations. It is this evidentiary burden that may provide a challenge for SMEs who may not have sufficient professional support to document their claim for safe harbour protection. It is also a key hurdle that employee entitlements are required to be paid in full.

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

There is no legal definition of phoenix activity (also known as phoenix arrangements or phoenix transactions) in the Corporations Act or in any other legislation.[54]

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"*.[55]

While it is not specifically defined in statute, the sale of a business assets to a related entity 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.[56] The statute also extends criminal liability to advisors who assist others in entering into such

---

[54] Phoenix activity is not defined by the *Corporations Act 2001* (Cth).

[55] Australian Government, Action Against Fraudulent Phoenix Activity, November 2009, Phoenix Proposal Paper, available at: <www.archive.treasury.gov.au/documents/1647/PDF/Phoenix_Proposal_Paper.pdf.

[56] *Crimes (Taxation Offences) Act 1980* (Cth) s 5.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

arrangements.[57] The penalty can be up to ten years in jail and a fine of up to $180,000.[58] The court can also order that an individual becomes liable to pay the outstanding tax liabilities. While the author has not found any 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 likely that the failure to prosecute under this statute for phoenix activity stems from the difficulty to prove beyond a reasonable doubt that there was an intention to avoid payment of taxes and debts.[59] The proof of intention on the part of the transgressor is an essential element of the criminal offence.

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 out by the ASC in 1996 found that 18% of SMEs had been adversely exposed to phoenix company activity.[60] 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 Corporations Act to apply to the Court to claw back assets or value in certain transactions.[61] Liquidators are under no obligation, however, to take this legal action if they have no funds to pay their own professional fees and legal costs.

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 Corporations 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

[57] *Crimes (Taxation Offences) Act 1980* (Cth) s 6.
[58] *Crimes (Taxation Offences) Act 1980* (Cth).
[59] Helen Anderson (2012) 'The Proposed Deterrence of Phoenix Activity: An Opportunity Lost', Sydney Law Review 34(3) 411, p. 417.
[60] Australian Securities Commission 1996, Research Paper No 95/01-Phoenix Companies and Insolvent Trading, Canberra.
[61] Discussed at Chapter 24.

uncover breaches of the law occurring as a result of the phoenix activity and take legal action.[62] 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 since it was passed.

Now, creditor-defeating dispositions are used to combat phoenix activity. The reforms were introduced as part of a widespread attempt to crack down on illegal phoenix activity across Australia at the beginning of 2020. Consequently, when a company transfers property for less than its reasonable market value during the winding up of a company or as part of a broader process of illegal phoenixing, liquidators can claw back those dispositions by suing both the director and any professional advisor.

A report from the Phoenix Research Team of Melbourne Law School called 'Defining and Profiling Phoenix Activity"[63] 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 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"*.[64]

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 breaches of

---

[62] Helen Anderson (2012) 'The Proposed Deterrence of Phoenix Activity: An Opportunity Lost', Sydney Law Review 34(3) 411, p. 417.
[63] Helen Anderson, Ann O'Connell, Ian Ramsay, Michelle Welsh, Hannah Withers 'Defining and Profiling Phoenix Activity', December 2014.
[64] Helen Anderson, Ann O'Connell, Ian Ramsay, Michelle Welsh, Hannah Withers 'Defining and Profiling Phoenix Activity', December 2014, p. 1.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

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 author'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 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 through the Fair Entitlements Guarantee scheme.

- *Illegal phoenix 3: 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 phoenixing of tax burdened companies.

34. 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, an unreasonable director-related transaction or a creditor-defeating disposition, the liquidator can have it overturned or have Newco or the directors compensate Oldco for the loss suffered.[65]

Uncommercial transactions

An uncommercial transaction is defined as a transaction where it "may be expected that a reasonable person 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."[66]

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.

Unreasonable director-related transaction

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".[67]

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.[68] Unlike with uncommercial transactions, the liquidator does not need to prove that Oldco was insolvent at the time of the director-related transaction.

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.

Creditor-defeating dispositions

Section 588FDB of the Corporations Act provides that a disposition of property is a creditor-defeating disposition if:

1. The consideration payable to the company for the disposition was less than the lesser of the following at the time the relevant agreement for the disposition was made or, if there was no such agreement, at the time of the disposition:

[65] *Corporations Act 2001* (Cth) s 588FF.
[66] *Corporations Act 2001* (Cth) s 588FB.
[67] *Corporations Act 2001* (Cth) s 588FDA.
[68] *Corporations Act 2001* (Cth) s 588FE.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

i. the market value of the property; or

ii. the best price that was reasonably obtainable for the property, having regard to the circumstances existing at that time.

2. The disposition has the effect of:

   i. preventing the property from becoming available for the benefit of the company's creditors in the winding-up of the company; or

   ii. hindering, or significantly delaying, the process of making the property available for the benefit of the company's creditors in the winding-up of the company.

The legislation further extends the concept of a disposition by providing that:

- If a company does something that results in another person becoming the owner of property that did not previously exist, the company is taken to have made a disposition of the property.
- If a company makes a disposition of property to another person and the other person gives some or all of the consideration for the disposition to a person (third party) other than the company, then the company is taken to have made a disposition of the property constituting so much of the consideration as was given to the third party.

A creditor-defeating disposition will be voidable under s 588FE(6B) of the Corporations Act if three criteria are met:

1. The transaction is a creditor-defeating disposition of property of the company.
2. At least one of the following applies:

   i. the transaction was entered into, or an act was done for the purposes of giving effect to it, when the company was insolvent, during the 12 months ending on the relation-back day or both after that day and on or before the day when the winding up began;

   ii. the company became insolvent because of the transaction or an act done for the purposes of giving effect to the transaction during the 12 months ending on the relation-back day or both after that day and on or before the day when the winding up began;

   iii. less than 12 months after the transaction or an act done for the purposes of giving effect to the transaction, the start of an external administration of the company occurs as a direct or indirect result of the transaction or act; and

3. The transaction, or the act done for the purpose of giving effect to it, was not entered into, or done:

i. under a compromise or arrangement approved by a Court under s 411; or

ii. under a deed of company arrangement executed by the company; or

iii. by an administrator of the company; or

iv. by a liquidator of the company; or

v. by a provisional liquidator of the company.

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 justifiable market value.

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.

35. How does the Fair Entitlements Guarantee treat employees when a business is liquidated?

The Federal Government provides direct financial support to employees who are owed unpaid employee entitlements following the insolvency or bankruptcy of their employer through the Fair Entitlements Guarantee (*FEG*). FEG is administered by the Department of Employment, Skills, Small and Family Business.

FEG is a legislative scheme set up by the Government as a last resort for employees whose employers have become insolvent.

Under FEG, employees are paid by the Government:

- 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;
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.[69]

There are also categories of persons that are excluded from eligibility under the FEG scheme including directors and relatives of directors. This means that business owners will be unable to utilise FEG to pay their own unpaid entitlements in an insolvency scenario.

Other exclusions from FEG eligibility include contractors of the company in liquidation. There is also an exclusion for contractors that converted from contractor status to employee status with the same employer within 6 months of the insolvency event.

The key limitation for the purposes of considering a pre-pack is that FEG will not pay out employee entitlements where there is a transfer of business to a related entity.

36. If employees are transferred from a company in liquidation, do employee entitlements also transfer?

If a company goes into liquidation and the business is transferred to a related entity, the Fair Work Act governs the requirements of the new employer to cover the entitlements of the employee. This may include unpaid wages, annual leave and sick leave but it does not include superannuation.

The transfer of business provisions under the Fair Work Act refer to the transfer of a business from one employer to another and impose obligations on the new employer to assume certain entitlements.

Pursuant to section 311(1) of the Fair Work Act, there is a transfer of business between the old employer and the new employer if the following requirements are satisfied:

1. the employee's employment with the old employer has terminated;
2. within 3 months after the termination, the employee is employed by the new employer;
3. the employee continues to perform the same or substantially the same work; and
4. there is a connection between the old employer and the new employer.

[69] *Fair Entitlements Guarantee Act 2012* (Cth) s 10.

A connection between the employers will exist, for the purposes of section 311(1), if:

- there has been a transfer of assets from the old employer to the new employer;
- the old employer outsources work to the new employer;
- the new employer ceases to outsource work to old employer; or
- the new employer is an associated entity.

Under the Fair Work Act, in certain circumstances where a transfer of business occurs, an employee's service with the old employer is required to be recognised by the new employer. Section 22(5) provides that the new employer will have to recognise an employee's prior service with the old employer if there is a transfer of employment.

This means that a new entity with the same controller will likely be required to meet the business transfer rules set out above and it will be liable for unpaid entitlements of transferred employees.

37. How can directors be penalised for phoenix activity and utilising FEG to pay outstanding entitlements?

In 2017 the Federal Government produced a consultation paper looking at whether further legislation should be enacted to stop FEG being utilised as part of phoenix activity. The report warned that FEG could be a moral hazard in some circumstances:

"The existence of the FEG scheme presents a moral hazard as it enables certain employers to arrange their affairs to prevent, avoid or minimise paying their employee entitlements with the knowledge that the government (and ultimately the taxpayer) will pay some or all of the entitlements. There is also some evidence indicating that unions, during bargaining for enterprise agreements, negotiate higher redundancy entitlements knowing that the FEG scheme can cover this in the event of an employer's insolvency."[70]

Notable critics of FEG argued that there were inadequate protections in place to stop FEG being utilised in support of phoenix activity: *"In our opinion, there needs to be a more targeted approach to removing the benefit of illegal phoenix activity from a phoenix Newco or from an existing holding company or beneficiary of the wrongful action"*.[71]

Part 5.8A of the Corporations Act introduced specific legislation to protect employee entitlements from transactions entered into for the purpose of defeating recovery of those entitlements. The entitlements include wages, superannuation, sick leave, annual leave and redundancy payments.

Section 596AB of the Corporations Act specifically prohibits directors from entering into an agreement or transaction with the intention of preventing or reducing the recovery of entitlements.

Under section 596AC directors can be liable for paying an amount equal to the loss or damage as a result of the transaction. That would mean the amount of unpaid wages,

---

[70] Reforms to address corporate misuse of the Fair Entitlements Guarantee Scheme, May 2017, p. 2.

[71] Anderson, H. Ramsay I, Welsh, M. Hedges, J. Phoenix Activity: Recommendations for detection, disruption and enforcement, February 2017, p. 100.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

superannuation, sick leave, annual leave and redundancy payments can be claimed against the directors.

The difficulty for liquidators enforcing claims for phoenix activity using section 596AB is that they will need to prove that the directors intended to prevent the recovery of entitlements. There is very little case law on this claim because it is difficult for liquidators to enforce. A 2015 Senate report recommended that the subjective element of proving intention be removed.[72]

38. What does the licensing of a business mean?

The concept of licensing 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, and although it is not formally recognised in Australia, licensing 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 licensing.

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 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 could be 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 licence, unless provided for under the terms of the licence.

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

[72] Australian Government, Senate Economics References Committee, 'I just want to be paid' Insolvency in the Australian construction industry', December 2015, ('2015 SERC Construction Insolvency Report'), recommendation 19.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

administration under the Deed of Company Arrangement, then 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.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

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

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 the 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 a 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 an 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 is 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 mandated 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 card 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 the money is used for, money easily accessible.
- Disadvantages of a Credit Card: Very High interest rate, director is 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 keep 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 guarantees 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 the 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 is 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.

Residential mortgage finance

Residential 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 historically very low 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.

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.

40. 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, 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 for the sale of a business or a 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 the 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 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.

41. What standards of valuation do courts expect for pre-pack insolvency arrangements?

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 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.

Creditor-defeating dispositions are now the baseline for individual assets such as plant and equipment, however there is no case law suggesting it extends to goodwill.

Case study: What is an uncommercial pre-pack?

In the case of the *Skouloudis Group*[73] a liquidator sought to set aside the 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:

[73] *Skouloudis Group Pty Limited v Planet Enterprizes Pty Limited* [2002] NSWSC 239.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

- 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 undertakings 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:

> *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:

- An expert 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.[74]

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

1. A pre-appointment review is undertaken of the insolvent company by the insolvency practitioner;
2. A conditional sale agreement is executed and a licence agreement to allow business to continue to trade through Newco is created;
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 is undertaken by the liquidator;
4. The liquidator is appointed and advertises the business for sale;
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 valuation methodology Crouch Amirbeaggi has adopted includes a valuation of goodwill. This is not required under the creditor-defeating dispositions framework because it mandates a breakdown of individual assets.

The Crouch Amirbeaggi approach has been made redundant by the introduction of creditor-defeating dispositions, as there is no room to push the value of the assets below what is required by law.

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;

[74] N. Crouch and S. Amirbeaggi (2011) 'Pre-Packs: A Legitimate means to Phoenix an Insolvent Company', 23(8) A Insol J, pp. 30-35.

- Prepare the 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.

42. 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 under the Corporations Act and 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.

43. 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.

44. 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.

45. 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 a 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,[75] and not to improperly use their position to make a gain for themselves or someone else, or to cause detriment to the corporation.[76]

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

[75] *Corporations Act 2001* (Cth) s 181.

[76] *Corporations Act 2001* (Cth) s 182.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

fraud is a person who, by any deception or dishonestly obtains property belonging to another, 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.[77]

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.[78]

There are many examples of sham or fraudulent transactions that have been entered into by insolvent companies. Such as in *R v Heilbronn*,[79] 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 a pretence and it involves the court finding that the real agreement entered into by the parties is something other than what 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.

46. Capstone comment: Why is it difficult to successfully execute a pre-pack insolvency arrangement?

The Australian insolvency regime is focused on two methods of restructuring an insolvent business:

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

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001

1. Voluntary administration and a compromise through a deed of company arrangement; and

2. An informal restructure through the safe harbour from insolvent trading.

The limitations on the voluntary administration regime are that it is public, has a chilling effect on business and has a very low success rate. The safe harbour is informal and ultimately relies on obtained consent from stakeholders.

Furthermore, when any asset is transferred before an insolvent liquidation, directors and their professional advisors need to make sure that value is paid or they may face a civil or criminal action brought by a liquidator or ASIC.

The benefit of a pre-pack insolvency arrangement is that a restructure can be executed without publicity and the consent of creditors. The transaction however, will be carefully examined by a subsequently appointed liquidator.

The difficulty with a pre-pack insolvency arrangement is making sure that the approach is coherent, legal and worthwhile:

- Coherent: It must make sense to all parties to avoid an allegation of secrecy or opacity.

- Legal: If the transaction isn't commercial (i.e. undervalued) it could be the subject of litigation by a liquidator.

- Worthwhile: If the business is unsustainable, the directors may be putting themselves in a worse position and lose the opportunity to work on or in a profitable business elsewhere.

Level 2, 255 Castlereagh Street, **Sydney** NSW 2000
Level 25, 600 Bourke Street, **Melbourne** VIC 3000
Phone: 1300 996 001