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Dr. Warren Mundy
Presiding Commissioner
Business Set-up, Transfer and Closure
GPO Box 1428
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Dear Dr. Mundy

By Post and Email

McGrathNicol Business Set-up, Transfer and Closure- Response to draft report issued on 21 May 2015

McGrathNicol is a leading national practice specialising in corporate restructuring and insolvency. Twenty of our partners are Registered Liquidators and the majority are members of the Australian Restructuring Insolvency & Turnaround Association (ARITA).

McGrathNicol partners have led many significant Australasian insolvency and or restructuring projects including Babcock & Brown, Centro, ABC Learning, ION, Great Southern, HIH, Commander Communications, Cubbie Station and Hastie Group to name just a few. In addition, the list of confidential restructuring projects we have undertaken is extensive and covers businesses of all shapes and sizes, from small private companies to listed multinational entities, across all key industry sectors.

We welcome the Commission's interest in improving the operations of the current insolvency regime and support many of the findings in the Draft report. We also appreciate the opportunity to make a submission in regard to the proposed areas of change.

We have made detailed comments below in relation to several areas dealt with in Chapter 15 of the Report on Business Set-up, Transfer and Closure (Draft report). Our comments are confined to corporate insolvency, and to the areas where we have concerns about the effectiveness of the proposed changes or differ from the Commission's view that there is a problem that requires rectification.

Support for submission from ARITA

McGrathNicol is an active supporter of ARITA we have seen ARITA's submission in regard to the Draft Report and generally support ARITA's proposals.

In particular, we endorse ARITA's:

- Support for the Commission's draft findings 14.1 and 14.2
- Comment regarding draft finding 15.1
- Support for draft recommendation 15.4. Indeed we consider introduction of a moratorium on ipso facto clauses in voluntary administration and schemes of arrangement to be a key reform which would significantly improve the effectiveness of these tools for restructuring.
- Support for draft recommendations 15.7
- Support for draft recommendation 15.8

We set out our comments in regard to the remaining draft recommendations below.

Interaction of reform proposals

An over-arching issue which we suggest requires attention in finalisation of the Report is to ensure that the recommendations are proposed as a complete and complementary suite of reforms.

Presently, and appropriately, the Draft Report treats each issue independently and proposes specific recommendations to address that issue.

It is important in the final recommendations that there is recognition of the interdependency within the issues. In our view, despite their individual merits, if each reform proposed in the Draft Report were independently and concurrently implemented, it would result in excessive complexity and bureaucracy which would add unnecessary cost and somewhat undermine the overall reform objectives. We have seen this problem arise in the (not yet enacted) Insolvency Law Reform Bill, as a result of layering solution upon solution, without due regard to the overall impact of the changes.

By way of example, it is our view that the introduction of an effective moratorium on ipso facto clauses would significantly influence the need for, or the form of, pre-position or pre-pack solutions; equally the availability and form of pre-positioning provisions may impact the extent or form of safe harbour provisions.

Draft Recommendations 15.2 -Safe harbour

McGrathNicol supports the 'safe harbour' protection concept as a means to encourage directors to take positive steps to act and engage appropriate advice in order to restructure and save a viable, but distressed, business from insolvency.

That said, it is our experience that the fear of insolvency trading claims does not significantly affect director behaviour:

- In the small owner/operator/director world, where the business represents a life's work or wealth, the prospect of insolvent trading claims weighs very little in the decisions made to survive.
- In larger corporates where the director risk is more about reputational damage, our experience is that directors do act pro-actively to avoid corporate failure, are supported by secured creditors to do so and do not pre-emptively seek formal insolvency solutions where there are alternatives which better preserve economic value for stakeholders.

We remain concerned at the moral hazard risk involved in safe harbour provisions. Accordingly, we concur with ARITA's view that any protection should be in the form of a defence to potential insolvent trading claims in the event that the restructure fails, not a regime into which a company is placed to provide directors with blanket protection.

The safe harbour provisions focus on the protection of directors; the advisers involved in safe-harbour work need to also be afforded comparable protection.

In regard to the Commission's information requests:

- In our view the first three issues are resolved by the concept of the safe harbour regime being a defence against actions available to be taken against directors in the event of insolvency. There should not be a limit on its use to restructure viable businesses, any abuse would be identified through the testing of the defence; it should not be necessary to arbitrarily limit the number of times the defence can be invoked.

- We agree that the quid pro quo for the safe harbour defence should be that insolvent trading offence be simpler to prove. Perhaps, in the event of alleged insolvent trading the provisions could be framed such that directors can only invoke the safe harbour defence to the exclusion of all other current defences and vice versa. That is, if such an offence is alleged they can either defend it on normal terms (not insolvent, date of insolvency, no debt incurred) or they can invoke the safe harbour defence, but not both.

Draft Recommendations 15.3- Pre-positioned sales

We generally agree with the proposition that the scope for ensuring a viable business continues to operate despite the insolvency of its owner would be enhanced by a legal framework which supports pre-positioned sales.

The need for business sales to occur in advance of formal insolvency is significantly addressed by reform to the rights to enforce ipso facto clauses on insolvency appointments. Reform in this aspect will relieve much, but not all of, the pressure for pre-positioned sales.

If a pre-positioned sale includes those where a sale occurs immediately pre-appointment in order to maximise the value of the assets and the continuity of the business, and if policy supports facilitating such outcomes, we would caution against the suggestion that a subsequently appointed liquidator should have the power to review and potentially over-turn the sale. To do so will likely render the reform ineffectual. If the reform is to be effective, third party purchasers need to have confidence that they can rely on the transaction entered into.

If a guard against such sales being at undervalue is necessary, in our view the better mechanism is for the liability for the sale at undervalue (the shortfall) to fall to the directors who can, if appropriate, invoke the safe harbour defence.

Where a sale is negotiated prior to the appointment of an external administrator but effected by the appointee post appointment, we agree that the legal framework should facilitate such sales provided the external administrator is satisfied that:

- the company has conducted an appropriate marketing campaign in all the circumstances; and
- the sale process has been designed and implemented to achieve maximum value for the business, again in all the circumstances.

If the external administrator is not satisfied in regard to these matters, he/she should not proceed with the sale.

We do not believe that a distinction between sales to third parties and sales to related parties is necessary. We note that sales to related parties are the most common form of pre-packs undertaken under the UK regime. This is not surprising given the preponderance of SME businesses in the corporate population, and the fact that in SME value is commonly inexorably linked with ownership and owner/operator knowhow. The pool of potential purchasers for such businesses is typically limited. Provided the independent external administrator is satisfied that the criteria above has been met, and that the transaction is not an illegal phoenix, it should not matter that the purchaser is a related party.

Draft Recommendation 15.5- Small liquidations

Whilst it is not a key area of practice for McGrathNicol, we support the concept that the overall insolvency regime would be enhanced if it better recognised that small and assetless insolvencies require a different process to large and complex trading businesses.

In our view there is significant challenge in striking the right balance between the streamlining of the liquidation process and interests of creditors in obtaining a return on their debts as well as the broader benefit of addressing and deterring director misconduct.

In this regard we are concerned that the "less than $250,000 of liabilities" threshold is open to abuse in terms of directors manipulating the information provided and will be difficult to apply in the majority of Australian liquidations, that is windings up initiated by Court orders, where information about the scope of the company's liabilities is often difficult and time consuming to obtain.

Perhaps the solution to the latter point is for the Court, on the recommendation of the petitioning creditor or ASIC, or the nominated liquidator, to determine whether or not the streamlined approach is to be ordered, subject to a requirement that the matter be converted to a full form administration if certain conditions arise – e.g. claims exceed the threshold, liquidator becomes aware of (i.e. is told by credible sources or discovers in passing, rather than through robust investigations) removed assets, uncommercial transactions, serious misconduct etc.

We are concerned that the removal of the requirement for the liquidator to conduct investigations into potential director misconduct will undermine attempts to identify and deter 'illegal phoenixing' activity and reduce the confidence of the community in the professionalism of insolvency practitioners and the effectiveness of the insolvency regime.

It is unclear how the streamlined process is intended to interact with the unfair preference regime within Division 2 Part 5.7B of the Corporations Act and if this regime will be excluded from the streamlined process.

In many respects we would advocate for its exclusion in order to obviate much expense, delay and frustration for creditors/ suppliers. In Attachment A we set out our observation that in the context of the Commission's consideration of the efficiency of the insolvency regime generally, the efficacy of the unfair preference is worthy of review.

In any case, the interaction of the preference regime and the proposed streamlined liquidation process will require some attention – for example, making a preference payment is a straightforward way to reduce liabilities potentially below the threshold.

We concur with ARITA's input regarding other means to streamline all liquidations by greater technological enablement, less duplication, removal of unnecessary process.

Draft Recommendations 15.6- Modifications to receiverships

McGrathNicol does not support the proposed changes to section 420A of the Corporations Act to modify the powers and duties of receivers on the basis of:

- our different view as to the extent of the underlying problem that these amendments are seeking to remedy; and
- practical and operational difficulties with the proposals.

Receivers appointed by secured creditors have the responsibility (as agent for the company and pursuant to legislation) to obtain the maximum value possible from or for the secured assets. This responsibility aligns

with achieving the best outcome for all creditors. It might mean the receivers continue to trade the business until alternative finance can be obtained or until the business as a whole can be sold. If neither of these outcomes can be achieved, the receivers are obliged to obtain the best prices for the property of the company, potentially on an asset by asset sale basis where a sale as a going concern cannot be achieved.

In all of these circumstances, the duty of the receivers to obtain the best price for the property is fully aligned with achieving the best outcome for the unsecured creditors.

We note our concerns previously expressed in Peter Anderson's letter to the Productivity Commission of 13 March 2015, that many of the complaints made about Australia's insolvency regime are anecdotal and poorly supported by factual evidence. We are concerned that the proposal around s420A seeks to respond to such complaints in the absence of sound evidence of the problem.

In all our experience, we are unaware of any valid example of the conduct of receivers being the cause of a viable restructure plan failing. There would be cases where viable businesses have been made subject to receivership after unviable restructuring proposals have been advanced and rejected by secured creditors. But typically, this only occurs after extensive negotiation as between debtor and creditor to seek to get an outcome which best maximises economic value – and sometimes this is only achievable through a receivers sale of the viable aspects of a business to a third party which has the financial and management capability to sustain it.

In relation to the practical issues we do not support the proposal that any proposed course of action by the receiver, particularly involving the sale of assets that are outside the normal course of the debtors business, should be the subject to a simple majority vote of all creditors.

Almost every sale of an asset by a receiver will be a sale outside the normal course of the debtors' business. Therefore this requirement, subject to the proposed waiver mentioned below, will apply widely and introduce further complexity and costs in virtually all cases.

We note the proposal that this requirement would be waived if, in the opinion of the receivers, there would be no funds to distribute to creditors.

- For a receiver to be able to form this opinion, he or she would need to obtain valuations for the sale of the assets. These will invariably be provided within a range based on the basis of the manner of sale, usually from auction realisation value though to sale as a going concern.
- The price obtained at auction or for sale may vary greatly depending upon whether there is one or more willing buyers on the day and what those buyers are prepared to pay.
- As a consequence the receiver may find him or herself in a position where they should have obtained the creditors' approval and didn't or obtained the creditors' approval unnecessarily (and subsequently have to explain to creditors why the expected value was not achieved).

If a reform of this nature were adopted, a range of further matters would require consideration or determination, for example:

- Does 'all creditors' include secured creditors and employee creditors whose entitlements are given priority or is it restricted to trade and unsecured creditors? Is the simple majority in value or number? How do the receivers adjudicate a dispute as to whether someone is a creditor of the company?
- What processes do the receivers have to follow notify the creditors of a meeting of creditors to vote on the proposal? What information is to be provided, how does this affect typical commercial confidentiality and competitive tension? How will this affect timeliness of action in the sale? What happens if a variation to an approved course changes through the sale process?

- How to manage lack of independence between creditors and potential purchasers (which is not uncommon)?
- Who bears the cost of calling a meeting to vote on the proposal?
- What happens if the creditors do not approve? What if they do not approve and despite further efforts a lower ultimate price is obtained and additional receivership costs incurred – impacting secured and priority creditors' returns – do they have a claim against the creditors?

It is our submission that there is a significant cost burden in having to work through all of these issues particularly in the context that we are not of the view that there is robust evidence of the problem being addressed.

Conclusion

We agree with the core draft finding of the Commission, that the Australian insolvency regime generally operates effectively with an appropriate balance of rights of interested parties and there is also a reasonable framework from which financially challenged businesses can attempt restructuring.

We also agree that that there is scope for a number of well-targeted reforms to be made to the current regime which would improve the efficiency of the processes governing both restructuring and insolvent business closures, but such reform must be considered and the reforms complementary so as to avoid adding complexity and cost. McGrathNicol would welcome such reform.

We thank the Productivity Commission for its work and for the opportunity to make this submission. We would be pleased to provide any further assistance.

Yours sincerely

Robyn McKern

Partner, CEO

CC:
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Enclosure(s):
Attachment A

Attachment A:

Observations in relation to the efficacy of the unfair preference regime

Division 2 Part 5.7B of the Corporations Act

A key theme of the Productivity Commission's inquiry and draft recommendations concerns the efficiency of the insolvency regime and an attraction to the concept of simplifying and streamlining "small" insolvencies.

In this regard we submit our observations in regard to the unfair preference regime which is a source of much expense, delay and frustration for creditors/suppliers in external administrations (liquidations)

The purpose of the unfair preferences section (588FA) is to ensure that unsecured creditors are not unfairly prejudiced by the company's disposition of assets or incurring of liabilities in a period before the winding up which would have the effect of favouring certain creditors. It does this by requiring parties who have unfairly been paid (or received security) for goods/services within 6 months of the commencement of the liquidation to disgorge those funds. The disgorged funds add to the pool of assets available for distribution and the creditor is entitled to prove for the now unpaid debt.

This theory is sound, but the reality rarely appears to achieve the policy objective.

We are not in a position to provide empirical evidence regarding how the regime plays out in practice but from our own experience, anecdotal evidence and such evidence as may be surmised from case law on the issue, we make the following observations.

Potential to prolong the period of financial distress

- The regime inherently dis-incentivises suppliers from "calling out" the debtor's insolvency.
  - One of the key defences to a preference recovery is not suspecting the debtor's insolvency. This defence is undermined when it is clear the supplier has been aggressively pursuing payment.
  - There is rarely upside for a creditor in being the party to instigate formal insolvency. Creditors are far more likely to press for payment, cease supply or supply on cash terms, and hope the 6 month period elapses before a formal appointment occurs.

Costly, litigious and adversarial process

- The case law surrounding preferences is extensive. The effect is that supplier/creditors need to seek legal advice to determine their prospects of defence. Typically in SME matters creditors find it more cost/time effective to settle a claim, even when the facts do not support a bone fide preference. SME creditors can perceive the practice of liquidators pursuing such preferences as tantamount to extortion.
- The structure of the law puts the liquidator and the supplier/creditor in an adversarial position and the interests of a single supplier/creditor at odds with the body of creditors. The creditor/supplier is treated as if they did something wrong or even illegal, even though all that occurred is that they received payment for goods/services in a period up to 6 months before the company failed - which is not of itself improper.
- Key aspects of the allegations (the insolvency of the entity on a particular date) and the defence (knowledge of the insolvency) are difficult and therefore costly to prove. Funds which might otherwise be available to creditors are diminished to pursue preference recoveries – whilst this would always be commenced with a view to recovering more than the cost of the pursuit, there is considerable litigation risk involved.

- The key defence in S588FA, that the recipient of the alleged preference had no reasonable grounds for suspecting that the company was or would become insolvent, requires the defendant to prove an absence of knowledge. This can and does lead to costly discovery processes.
- Unless parties otherwise settle, it is a Court process and so inherently costly and slow to resolve.

Impact on Voluntary Administration outcomes

- As preference recoveries are only capable of pursuit in a liquidation, they may form an important factor in the decision as to whether creditors will accept a DOCA or not. Typically:
  - In the S439A Report to creditors, the liquidator can only indicate the quantum of potential unfair preferences that may be prosecuted. Typically at this early stage, it is impossible to know, let alone assess the merits of, the defences that the potential preference recipients may mount and the costs of pursuit.
  - Creditors who may also be potential preference recipients may be biased towards acceptance of DOCA because it relieves them of the potential preference claim and the burden of defending such a claim.

Duty, costs, returns

- The law does not offer the liquidator an option. It provides that unfair preferences are recoverable property and there is an implicit expectation that liquidators have a duty to investigate and seek to recover such property. The relief to not pursue an action due to a lack of funds may be complicated by the availability of litigation funding.
- The practitioner is commonly in a position of "damned if you do, damned if you don't". Failure to pursue apparent potential unfair preferences is no more welcomed by the body of creditors than pursuing preferences which ultimately prove sufficiently defensible that a settlement ensues which may only cover costs incurred, but importantly avoids adverse costs.
- The practitioner cannot know all the circumstances of a creditor/supplier relationship with the company, nor their appetite for defending a claim, and preference matters which look straight forward on commencement can become complicated and costly.
- It is not uncommon for the liquidator's time and legal costs to absorb significant proportion (indeed all or more than) of the ultimate preference recoveries. This can arise for several valid reasons – although it can be seen how the perception of liquidators pursuing actions in order to fund their time costs in pursuing those actions may arise, to the detriment of the practitioners and the profession.

The above outlines just some of the features of the unfair preference regime which lead us to the conclusion that it should be reviewed and its effectiveness assessed in terms of the underlying policy objective.

Our view is that in its current form it is largely ineffective in policy terms and creates undue delay, frustration, leakage of funds to practitioners and lawyers and adverse perceptions of the insolvency profession.

Opportunities to improve the regime, may include:

- Limiting claims to amounts which are material to the administration
- Abolishing it in the streamlined process
- Limiting the relation back period to say 3 months
- Simplifying the elements of proof/defence