14 July 2015

AUSTRALIAN GOVERNMENT PRODUCTIVITY COMMISSION
Andrew.irwin@pc.gov.au

Dear Andrew

BUSINESS SET UP, TRANSFER & CLOSURE INQUIRY
SUBMISSION FOR INQUIRY: INSOLVENCY REFORM

I am a liquidator and trustee in bankruptcy with approximately 25 yearsô experience. My submission to the Productivity Commission is contained herein. I would be delighted to discuss the contents with your office at any time.

EXECUTIVE SUMMARY

ASIC should issue a Regulatory Guide that promotes the use of Pre-Packs that is similar to the UKös Statement of Insolvency Practice 16 that enables a small business to restructure (or phoenix) and survive an insolvency event without using a Voluntary Administration.

The *Corporations Act 2001* needs to adopt a similar provision to section 181 of the *Bankruptcy Act 1966* that empowers creditors to remove a liquidator via a resolution of creditors. Safeguards should be developed to ensure the provision is not abused by creditors. I feel this is the single most important reform the industry requires.

Creditors should be encouraged to engage special purpose liquidators to undertake distinct aspects of a large scale administration. For example, in the Ansett Airlines matter creditors should have engaged 4 separate firms/liquidators to undertake specific tasks, including: -
1. Asset sales,
2. Investigations,
3. Litigation, and
4. Employee entitlements & dividends.

Multiple liquidators/firms competing on price and time to complete defined tasks that are chosen by creditors, will ensure matters are dealt with in the best interests of creditors on terms that creditors dictate and not to the benefit of liquidators and lawyers who cannot be readily removed.

Encouraging creditors to appoint special purpose liquidators to pursue voidable transactions that an original liquidator elected not to pursue will make phoenix type behavior harder to bury by bad liquidators and ASICös job easier.

Illegal phoenix behavior would be materially more difficult if the onus of proof was reversed when voidable transactions of related parties are pursued.

SYDNEY Tel: 02 8262 9333 | Fax: 02 8262 9300 | Suite 403, 55 Lime Street, King Street Wharf, Sydney NSW 2000
MELBOURNE Tel: 03 9975 7108 | Fax: 03 9975 7109 | Ground Floor, 187 Park Street, South Melbourne VIC 3205
ALL CORRESPONDENCE TO SYDNEY admin@crouch.com.au | www.crouch.com.au | ABN: 26 131 856 169

F:\ADMIN\Pre-packs\productivity commission v2 .docx

VA IS NOT A VIABLE OPTION FOR SME OWNERS

It is impossible for the majority of insolvent small companies to use the VA framework to restructure.

I cite the following by way of background information:-

In 2013, ARITA reported:

- The average cost of a VA was $54,670;
- The average cost of a DOCA $28,772;
- Total professional fees cost $83,442.

ASIC Report 412 Insolvency Statistics to June 2014, at Table 30 states:-

- 80% of all corporate failures have less than 25 creditors;
- 75% of all corporate failures have less than $500K in creditors.

Various ASIC annual reports show 95% of liquidations do not pay any dividend.

In short, thereõs simply no money left in 75% of the 10,000 companies that go broke each year.

The mums and dads who own these 7,500 SMEõs donõt even have the money to keep trading let alone a spare $83K to pay an administrator.

PRE PACKS

The Productivity Commission makes a 1 page reference to pre-packs at page 358 of its draft report.

I submit the Productivity Commission should reconsider the contents of UK Governmentõs 2014 enquiry into pre-packs (The Graham Review) to ensure Australia has the worldõs best practice to facilitate a restructure of an insolvent small company.

See
(https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration)

Page 28 of the UK Governmentõs Graham Review states the following countries use pre-packs to help small companies restructure:

- UK
- Belgium
- Czech Republic
- France
- Germany
- Italy
- The Netherlands

The US also uses a variation of the pre-pack model. The most famous example was the General Motors restructure. New GM Inc paid $50B for the assets from the insolvent GM Inc. The deal took 30 days to put together. It was a great example of a successful phoenix preserving about 200,000 jobs.

Sadly, ARITA and ASIC are 13 years behind our UK counterparts and we no longer have the worldõs best frameworks to assist business survive insolvency.

A pre-pack can be defined as:

> *A process of arranging the sale of a company's business before the formal appointment of a liquidator is effected; with a view to the newly appointed liquidator finalising the sale as soon as practicable after their appointment.*

PRE-PACK HISTORY

Since the introduction of the concept of trading via a company in the 1800s people have purchased the assets from the wreckage of failed companies and used those assets to trade in new company shells. The voluntary administration framework is merely a variation of this practice of recycling or ñphoenixingò assets into a new clean skin company. Pre-packs are the latest variation of this process.

Pre-packs were developed in the UK about 13 years ago and they do not rely upon a statutory framework. Pre-packs were developed from common practice, judicial support and a statement of best practice (SIP 16) issued by the professional bodies who practice insolvency.

ASIC could today issue a similar Regulatory Guide on pre-packs which could be a cut and paste of the UKõs 3 page guide. Thereõs no doubt the good people at ASIC could also tweak and improve the UK version.

Pre-Pack Statistics

Research into the pre-pack process is summarised below: -

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

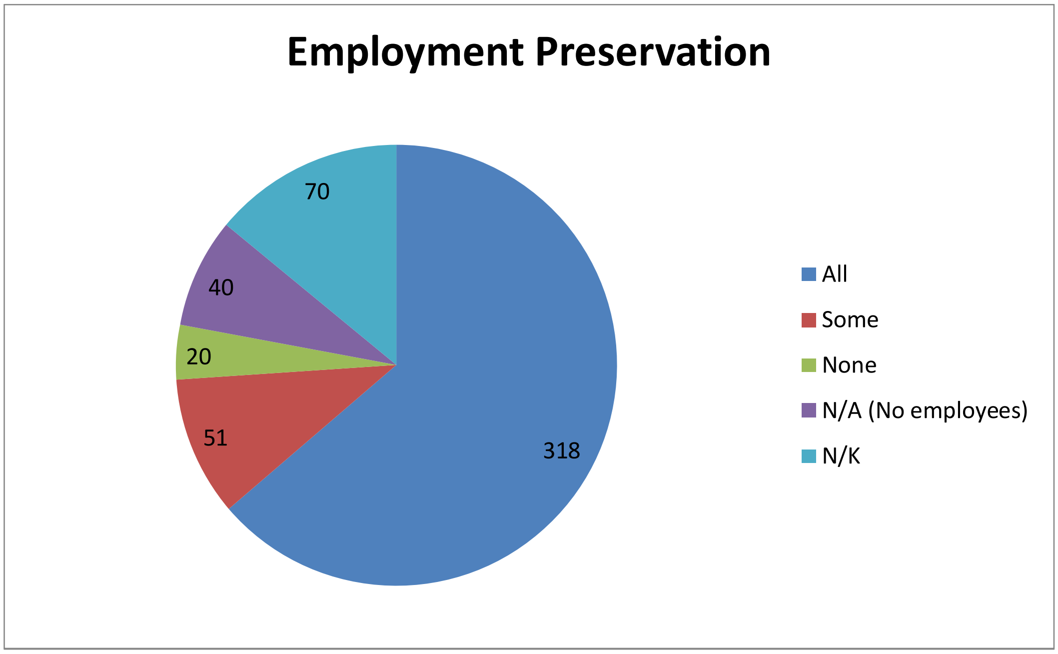
Source: Frisby SA ñPreliminary analysis of pre‑packed administrationsò 2007 *https://www.r3.org.uk* (follow the Publications link).

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

PRE-PACKS SAVE JOBS

Statistics I obtained from ASIC on behalf of Senator Williams in 2010 showed that only 4% of the 10,000 companies that go broke each year will complete their obligations under a deed of company arrangement (VA). i.e. only 4% of companies will successfully restructure by using the VA framework.

This can be contrasted with the UK where the UK Governmentõs Graham Review which found that pre-packs have a 96% success rate of preserving existing employee jobs (see page 25 of the report; note only 20 of the 499 pre-packs used in the sample failed to retain staff. The majority of these were in circumstances where the business was shut down prior to liquidator being engaged).



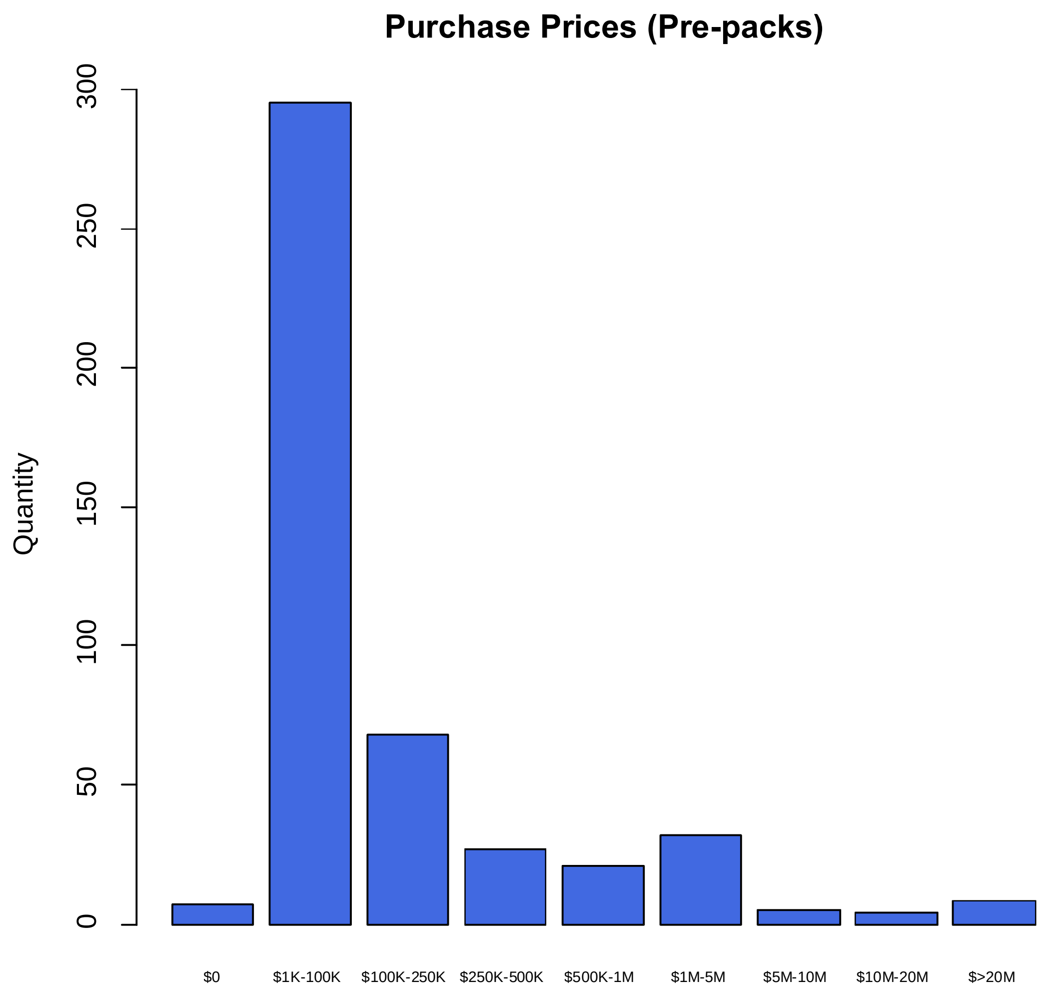
If saving jobs is the benchmark to determine if the insolvency laws help a business, thatôs a 4% success rate for the Australian framework and a 4% failure rate in the UK.

Clearly our system is not effective and the UK has a model that works.

ONLY SMALL BUSINESS USE PRE-PACKS

Page 26 of the Graham Review indicates the vast majority of pre-packs are used by companies that have under $100K in assets.

See Next Page



mean=6.67 million median=54,500 Q25=25,000 Q75=177,500

I note the average purchase price for assets sold in a pre-pack is about $54,500 (or about $A112K)

So pre-packs are used by small business to sell their business.

PRE-PACKS ARE 50% CHEAPER THAN ADMINISTRATION

Page 83 of the empirical research that supports the UK Governmentõs review into pre-packs (The Graham Review) states:

ñSome comparison of insolvency practitioner (ôIPö) fees charged and drawn down in both pre-packs and going concern sales may illustrate this point. In a third of the going concern sales considered, the business was sold within 14 days. In those cases, on average, the IPs charged fees of £169,929 of which £114,243 was on average drawn. In pre-packs, the average fee charged was £87,882 and the average fee drawn was £64,451.ò

These rarely quoted statistics show that in the UK pre-packs are about 50% cheaper than administration.

ARITA'S PRE- POSITION MODEL

13 years after the UK started using pre-packs and 6 years after the release of UKõs regulatory guide on pre-packs Statement of Independence 16, ARITA has finally released their preferred SME framework to help a small business restructure.

At page 35 of their discussion paper ñA Platform for Recovery 2014ò, (discussed at page 357 of the Commissionõs draft report) ARITA describes their prepositioning model as their preferred SME restructure model.

Itõs a vague proposal that is incapable of implementation without profound reform of the Corporations Act.

As a liquidator who is about to retire, throughout my entire commercial life I have seen only one meaningful reform of the Corporations Act (which was in fact a bi-product of the introduction of the PPSR). It is a mistake for ARITA to make such a vital reform contingent upon a rare change.

Even if the Corporations Act is reformed, the ARITA model is flawed and inoperative in its current form.

TWO LIQUIDATORS BOTH WORKING ON A SMALL COMPANY?

ARITAõS model (discussed above) requires 2 liquidators to be used to implement a SME restructure.

ARITA ignores the fact that 75% of SMEõs donõt have any money and can barely afford to use the services of 1 liquidator.

This model is simply not commercially viable for the vast majority of SME owners. It is incapable of helping mum and dad business owners because they will not have the money to pay 2 sets of liquidators.

ARITA'S CRITICISM OF PRE-PACKS

ARITAõs criticisms of pre-packs warrants some review.

At page 33 of ARITAõs 2014 discussion paper ñA Platform for Recoveryò, ARITA cite as defects of pre-packs the following:-

- 60% of pre-packs do not pay a distribution to unsecured creditors. But ARITA fails to note that ASIC reports show 95% of insolvent administrations do not pay a dividend.

- 30% of Newco enterprises fail within 3 years of a pre-pack, but ARITA fails to acknowledge the ABS Australian average rate of failure is > 50% in 3 years.

- 65% of all pre-packs are sold to related parties. Who cares? Related parties have been purchasing assets from failed companies for over 200 years.

The key issue for creditors is what price is paid for ñtheir insolvent companyõs assetsò.

It is vital to distinguish between the process of realising the greatest benefit for creditors from the wreckage of an insolvent company and the process of prosecuting directors for breach of their duties.

Pre-packs do nothing to prevent ASIC, liquidators or creditors from pursing directors for breach of their fiduciary duties.

Pre-packs merely facilitate a cost effective restructure of an insolvent business. Pre-packs offer a means to realise the object of section 435A of the Corporations Act, which states the purpose of VA is to *"maximise the chances of the company, or as much as possible of its business, continuing in existence."* Pre-packs can realise this objective about 50% cheaper than a VA.

ARITA also argue that valuations used to support pre-pack sales can be dubious, as they fail to take into account intangibles such as goodwill and intellectual property. This ignores the fact that pre-pack sales are almost exclusively being used in the UK for micro business, with only 25 creditors who have failed to successfully trade.

It is very rare for a small insolvent business to have any material value in its intangibles. If there was any value, liquidators of the 7,500 small companies that go broke each year would realise this value and the rate of dividends paid to unsecured creditors would be more than a mere 5%.

I am perplexed and utterly frustrated by the failure of ARITA to propose a viable pre-pack hybrid that will assist SME owners to restructure.

VALID CRITICISM OF PRE-PACKS

The Graham Review righty points to 2 material defects in the UK pre-pack model: -
1. Lack of independence of the liquidator;
2. Lack of transparent marketing.

Both these issues can be addressed by varying the UK model with a better Australian hybrid version.

AN AUSTRALIAN HYBRID PRE-PACK MODEL?

I am very reluctant to propose an alternative pre-pack model. I am aware of my own skill set limitations and appreciate the contributions other experts and ASIC can contribute far exceed my abilities.

A few years ago, I assembled a team of wonderful insolvency experts, which included Ron Harmer, Michael Quinlan, Bernie Coles and select academics and bankers in an attempt to develop such a model for the benefit of Senator Williams Senate enquiry into Insolvency.

Unfortunately my project stalled when both ASIC and ARITA failed to embrace developing a preferred model. However, if the commission wanted to develop a preferred pre-pack model it would be possible to utilise the services of these industry experts.

I suggest that any Australian version prepacks require liquidators assisting directors with a pre-pack are required to comply with an equivalent of section 420A of the *Corporations Act 2001* (which requires a receiver to ensure market value is realised when selling assets).

If a liquidator's registration is on the line, creditors could be significantly more confidant that appropriate advertising and direct marketing of the available assets of a small insolvent business was undertaken.

In this regard, it is vital to recognise pre-pack sales are historically used by small insolvent businesses which typically sell for less than $100K. As an official liquidator, I have sold hundreds of these types of small businesses. I am certain that marketing campaigns do not need to be extensive and lengthy for these types of business. It is my experience that the costs of longer term sales far exceed the premium in revenue when compared to a short term sale.

The adage ña quick sale is a good saleò remains true for small insolvent companies.

I contend that 2 weeks can be an adequate time period to sell a small insolvent business.

Trading during this time should be on a COD basis.

The liquidator should not be responsible for trading during a pre-pack sale.

I contend that SMEös will use a pre-pack option, but larger companies that can afford a VA will continue to use that framework to restructure as it offers greater certainty and control for stakeholders.

If creditors are unhappy with the liquidatorös work, they should be empowered to replace the liquidator with another who can review the sale.

ILLEGAL PHOENIX BEHAVIOR

My final observations that I wish to make follow.

Page 23 of Productivity Commissionös overview states:-

"There are reported to be around 6,000 businesses involved in phoenix activity, at a total cost to employees, business and government of $1.8 to $3.2 billion per year.ò

The source of the statistic is not cited, but it is most likely from the 2012 report by PWC for Fair Work Ombudsman Phoenix Activity report called Sizing the Problem and Matching-Solutions.

Source: See PWC report at page 25

http://www.fairwork.gov.au/about-us/news-and-media-releases/2012-media-releases/july-2012/20120704-phoenixing-report

I suggest the 6,000 figure grossly overstates illegal phoenix behavior and instead accidently includes legitimate related party restructures.

With respect to PWC, it cannot be reconciled with the 2001/02 ASIC annual report which suggests, 1.6% of liquidator complaints (194 complaints) received related to phoenix activity and the ATOös view that it finalised 124 phoenix cases in 2009 support my submission.

What is prevalent in the industry today is approximately 20 pre insolvency experts who call all 7,500 small companies as soon as they hit the Court winding up list to offer phoenix solutions with varying legitimacy.

Desperate directors with little or no corporate law experience commonly fall for slick sales guysô kind words and promises of a new start.

ASIC must intervene and stop this unregulated practice because the mums and dads often pay large sums for services that do not provide any benefit. They are becoming victims of unscrupulous pre insolvency sharks. ASIC needs to help these people.

ASIC has failed these individuals by not offering to produce a Regulatory Guide like the UK’s SIP 16 and instead devoted its limited resources to policing illegal phoenix behavior. History shows prohibition is difficult and education is always a more successful option.

ARITA has simply abandoned the 7,500 unsophisticated directors who each year have their house and marriage on the line by failing to provide any guidance on what is an alternative legitimate restructure practice.

PREVENTING ILLEGAL PHOENIX BEHAVIOR

The best solution to avoid illegal phoenix type conduct is to reverse the onus of proof on director related transactions.

Liquidators would pursue illegal phoenix transfers if the legislative framework made it easier.

Liquidators, with their self interest in mind, will do a much better job enforcing this change than ASIC and this would free up ASIC’s limited resources.

To effectively phoenix you need a liquidator who is happy not to litigate an available recovery. i.e. a liquidator who is prepared to bury the job.

Adopting the Bankruptcy Act’s process of replacing a trustee to liquidators would make it harder to bury a job as creditors will have increased capacity to change liquidators.

CONTROLLER’S DUTIES

The public policy objectives that support section 420A of the Corporations Act are adequately realized by the current section.

It’s a well written, simple statutory obligation that codifies longstanding principles. I wish more of the Corporations Act was this clear.

The weakness of this provision is not in the drafting but in its varied application by the judiciary.

I’m against any amendment of section 420A of the Corporations Act.

I do strongly advocate for stakeholders of a receivership to be given a statutory right to access the basic information regarding the process.

The right should be similar to the rights of creditors in a committee of inspection in a liquidation.

Stakeholders should be entitled to:

- A description of the proposed process;
- The results of the sale process; and
- Full particulars of proposed and actual costs and disbursements.

Controllers should be compelled to have regard to the stakeholder’s views in the same way that a liquidator must.

Stakeholders should be given the opportunity to seek injunctive relief in sales and fee payments.

In the current model, if a secured creditor will be paid in full, there is simply no incentive for them to closely scrutinize the process or costs of their receiver.

This creates a risk that the costs of realization can be excessive. The stakeholders will normally be incapable of challenging the process due to the inherent barrier of costs in litigation.

The current model is an inherently unfair structure.

CONCLUSION

I welcome a discussion regarding the contents of this submission.

NICHOLAS CROUCH

CROUCH AMIRBEAGGI
PARTNER