14 November 2019

Insolvency Inquiry Reference Group

Attention: **Jill Lawrence**
Emai: **Jill.Lawrence@asbfeo.gov.au**

Dear Jill,

SUBMISSION FOR INQUIRY: INSOLVENCY REFORM & PREPACKS

I attach herewith some notes and comments on prepacks for the Insolvency Inquiry to consider.

I would be delighted to discuss the contents with your office at any time.

EXECUTIVE SUMMARY

I recommend the Australian Small Business and Family Enterprise Ombudsman ("the Ombudsman') co-ordinate the development of a new regulatory framework that will help small business survive insolvency.

Professor Fisher (co - author of the voluntary administration ("VA") framework) has recently drafted a new mini VA framework for this purpose.

This framework is based upon the UK "Prepack" framework which has been in operation for over 15 years.

The Productivity Commission has recommended ASIC, with the assistance of the Ombudsman, issue a Regulatory Guide and effectively develop a new framework.

It is appropriate to undertake a consultation process to critique Professor Fisher's prepack framework and consider further refinements as prepacks have not been universally embraced by all stakeholders.

BACKGROUND

I detail below some relevant statistics, noting that they are somewhat dated. ASIC will be in a position to provide up to date statistics. In the meantime, the statistics available here are sufficient to demonstrate the issues at hand.

ASIC statistics suggest that approximately 4% of the companies that enter into external administration will use our voluntary administration framework to restructure and avoid insolvency.

In 2013, ARITA reported: -

- The average cost of a VA was $54,670;
- The average cost of a deed of company arrangement ('DOCA') was $28,772;
- Total professional fees were $83,442.

It should be noted that the medium costs in a relevant sample of 41 external administrations were $60,272 ($31,500 & $28,772).
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.

Report 456 Table 42: (1 July 2014 to 30 June 2015) at page 55 states: -

- 93% of external appointments pay no dividend;
- 87% of liquidations have liquidator fees of less than $50K

I interpret this data to suggest that 87% of the 8,000 to 10,000 companies that enter into external administration each year have less than $50K in assets.

If this conclusion is correct, it follows that around 87% of the companies that enter into external administration each year cannot afford to use the voluntary administration framework to avoid insolvency because: -

- the costs of voluntary administration are $60K to $80K; and
- the available assets are up to $50K.

NEW FRAMEWORK URGENTLY NEEDED

I contend it is universally agreed by all stakeholders that Australia needs a new statutory framework to assist small business survive insolvency.

Unfortunately, there is no universal agreement on the form of this framework.

AUSTRALIA'S PREPACK FRAMEWORK

One of the co-authors of the voluntary administration framework, Professor Fisher, has drafted a new cost effective regulatory framework that, if adopted, may assist small business owners survive insolvency.

It is proposed the new framework would be limited to SME companies via a prescribed threshold; maybe $100K in assets and $1M in liabilities (Professor Fisher has invited the AIIP provide feedback on the preferred threshold).

The Bankruptcy Act has a similar mini bankruptcy framework and limitations which Professor Fisher also drafted (see Part IX of the Bankruptcy Act).

The new small business framework written by Professor Fisher is based upon the UK "Prepack" framework.

PREPACKS ARE NOT UNIVERSALLY ENDORSED

It must be stated, prepacks are contentious.

The UK Government has undertaken 3 reports into prepacks which evaluated their benefits during the past 15 years wherein prepacks have been used in the UK.

The UK Government has concluded: -

- Prepacks save jobs and small business from insolvency;
- Prepacks are cheaper than a voluntary administration.

Most of Australia's major trading partners have similar prepack frameworks.

In 2015, the Australian Productivity Commission endorsed the introduction of a new small business framework in Australia as a means to assist small business owners.
(see recommendation 14.4, 15.1 & 14.3)

The Productivity Commission recommended ASIC and the Small Business Ombudsman produce a Regulatory Guide targeted at small businesses facing financial difficulty.

The Productivity Commission* stated: -

> *"The options for restructure [of an insolvent company] involve professional expertise and therefore incur costs reflecting this — the typical voluntary administration costs $60,000.*
> *Crouch Armibeaggi suggested an Australian hybrid model [Prepacks] that could avoid these costs, assuage creditors' concerns and present small to medium enterprises with a genuine option for restructure."*

*see recommendation 15.7

The Productivity Commission endorsed, but did not recommend my prepack model. Instead it endorsed ARITA's Hybrid prepack model, known as Pre-Position Framework (discussed later).

ASIC has not embraced prepacks or the Pre-Position Framework and has advised me it will wait for the Government to implement all legislative reforms before acting on the 2015 recommendations.

It may be appropriate to invite ASIC to clarify if it now wants to act on the recommendations of Productivity Commission given the passage of various legislation.

In May 2017, the Government refused to adopt the prepack framework the Productivity Commissioner supported on the basis *"they had attracted considerable criticism because of perceptions that it may facilitate fraudulent phoenix activity"* (see page 27 of Australian Government response to the Productivity Commission Inquiry into Business set-up, Transfer and Closure May 2017).

Following from this rebuttal, I was fortunate to meet with Professor Fisher and offer him my research and encourage him to design an improved prepack framework.

Professor Fisher's framework was written with the benefit of the above reports and after the introduction of an amendment to the Corporations Act, being section 90-35 of the *Insolvency Practice Schedule 2016.* This new section allows for a streamlined process to remove a liquidator where creditors lose confidence in their performance or suspect a conflict of interest. This section was introduced as part of the law reform in March 2017, following lobbying by Senator Williams and I.

Section 90-35 of the *Insolvency Practice Schedule 2016* offers inherent protection from concerns that a liquidator and director are engaged in phoenix conduct. If creditors suspect there's a illegal phoenix transaction or they lose confidence in the liquidator, they now have the power to simply and cheaply replace a liquidator and ensure the issue is investigated and

prosecuted.
Consequently, this new legislative reform makes Professor Fisher's prepack framework the preferred framework for Australia.

Furthermore, if Professor Fisher's prepack framework was adopted, illegal phoenix activity is likely to be materially reduced as asset sales would be undertaken by registered liquidators and not unlicensed pre insolvency advisers.

This would be a material benefit to small business owners who typically spend their last funds on pre insolvency advisers before meeting licensed liquidators.

PRE PACK REPORTS IN THE UK

There are several Government reports into the operation of prepacks in the UK. Perhaps the most comprehensive is the UK Government's 2014 enquiry into pre-packs (the Graham Review) the link is: -

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

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

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

A pre-pack was defined in that report as follows: -

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
Pre-packs were developed in the UK about 15 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. SIP 16 when first introduced was a mere 3 page Regulatory Guide of best practice.

PRE-PACK STATISTICS

Research into the pre-pack process in the UK 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 "Preliminary analysis of pre-packed administrations" 2007 *https://www.r3.org.uk* (follow the Publications link).

PRE-PACKS SAVE JOBS

Statistics I obtained from ASIC on behalf of Senator Williams in 2010 showed that only 4% of the 8,000 to 10,000 companies that enter into a formal insolvency administration each year will restructure under a DOCA (through a VA).

That is; only 4% of companies will successfully restructure by using the VA framework.

This can be contrasted with the UK where the Graham Review found that pre-packs have a 96% success rate of preserving existing employee jobs. Refer 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.

ONLY SMALL BUSINESS USE PRE-PACKS

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

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

PRE-PACKS ARE 50% CHEAPER THAN ADMINISTRATION

Page 83 of the empirical research that supports the Graham Review into pre-packs states: -

> *"Some comparison of insolvency practitioner ('IP') 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."*

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

ARITA'S PRE- POSITION FRAMEWORK

At page 35 of their discussion paper "A Platform for Recovery 2014", (discussed at page 357 of the Commission's draft report), ARITA describes their Pre-Position Framework as their preferred SME restructure model.

ARITA have produced a framework that is viable for large corporate insolvency matters.

TWO LIQUIDATORS BOTH WORKING ON A $50,000 SALE OF ASSETS?

ARITA's Pre-Position Framework requires 2 liquidators to be engaged; larger insolvent administrations can easily afford this overhead.

Unfortunately approximately 80% of SME's have up to $50K in assets.

It follows a Pre-Position Framework may be the preferred model form a regulatory perspective, but it is simply not a viable option for the vast majority of small business owners; because they

will not have the money to pay for 2 liquidators as they supervise the sale of $50K in assets. Professor Fisher's model overcomes this limitation by utilising one liquidator.

ARITA'S CRITICISM OF PRE-PACKS

ARITA's criticisms of pre-packs warrants some review.

At page 33 of ARITA's 2014 discussion paper "A Platform for Recovery", ARITA cite the following as defects of pre-packs: -

- 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; but related parties have been purchasing assets from failed companies for centuries. A sale of this nature does not create an illegal phoenix, it is a legitimate phoenix sale of assets.

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.

Arguably the voluntary administration framework is merely a variation of a centuries old practice of recycling or "phoenix sale of assets" into what is effectively a new clean skin company.

Pre-packs do nothing to prevent ASIC, liquidators or creditors from pursing directors for breach of their fiduciary duties aka illegal phoenix behavior (where assets are not sold at market value or creditors are intentionally defrauded).

Pre-packs merely offer the most cost-effective restructure framework for a small insolvent business.

Section 435A of the *Corporations Act*, states the objective of the VA framework is to *"maximise the chances of the company, or as much as possible of its business, continuing in existence."*

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 (i.e only 25 creditors) which almost never have goodwill.

I am perplexed by the failure of ARITA to propose a viable prepack framework that will assist small business owners to restructure. I note that the ARITA Board is dominated by lawyers, bankers and liquidators from the 15 large firms who employ about 50% of all liquidators in Australia.

By contrast, the AIIP, which was established 2 years ago, has approximately 160 of the 650 liquidators in Australia as members. The AIIP has excluded bankers and lawyers from its membership base to ensure this professional body remains focused on small insolvency firms who specialise in restructuring of small businesses.

The AIIP have a prepack reform group which has tentatively endorsed Professor Fisher's prepack framework and they have set up a committee to assist this Inquiry.

VALID CRITICISM OF PRE-PACKS

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

Both of these issues have been addressed by Professor Fisher's framework.

OTHER ISSUES

PREVENTING ILLEGAL PHOENIX BEHAVIOR

A potential solution to materially reducing illegal phoenix 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.

CONTROLLER'S DUTY TO SELL AT MARKET VALUE

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

It's a well written, simple statutory obligation that codifies longstanding principles.

The weakness of this provision is the cost of enforcement.

At the AIIP annual conference this year, Justice Lee of the Federal Court of Australia proposed the Court use experts on a more regular basis to make assessments of matters that would normally be assessed by the Court.

Justice Lee's practice is to limit submissions and time for hearing by experts in his Court. The expert decision may be reviewed, (on appeal if you like) by the Court.

This process allows parties a cheaper and quicker access to courts which are currently inaccessible by small business owners.

I invite the Ombudsman to encourage Government to formally adopt this process where possible.

IMPROVED PROCESS TO EXAMINE DIRECTORS/PERSONS OF INTEREST.

Section 77C of the Bankruptcy Act should be adopted into the Corporations Act.

Simply, this section permits a mini public examination of a director at a fraction of the cost that is required via the Courts. (It saves about $30K to $50K in costs for a day in court).

Anything that materially reduces legal and investigation costs should be adopted without delay.

CONCLUSION

Australian small business owners need a new regulatory framework to save their business

from insolvency.

The pre-pack framework proposed by Professor Fisher is the best option available.
A consultation process to critique Professor Fisher's prepack framework and consider further refinements should be encouraged to improve this framework before it is finalised and adopted as an ASIC Regulatory Guide.

I thank the Ombudsman and Chairman of the Inquiry for the opportunity to assist your inquiry.

I hope the Ombudsman promotes:

- A new framework that helps small business owners survive insolvency; and
- Adopts new procedures that materially reduce the costs and time of litigation and administration of a small business insolvency.

I welcome a discussion regarding the contents of this submission.

NICHOLAS CROUCH

CROUCH AMIRBEAGGI
PARTNER