PREPACKS

EXTRACTS FROM PRODUCTIVITY COMMISSION REPORT

BUSINESS SET-UP, TRANSFER AND CLOSURE
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https://www.pc.gov.au/inquiries/completed/business/report

The following is an extract from page 387. We have underlined some comments at page 6 & 7 to assist readers who have a focus on prepacks.

In 2015, the Federal Government's Productivity Commission undertook the most comprehensive review of insolvency industry in the past 20 years.

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 Amirbeaggi suggested an Australian hybrid model that could avoid these costs, assuage creditors' concerns and present small to medium enterprises with a genuine option for restructure."***

The Commission made 13 recommendations to reform corporate insolvency law and practice in Australia; 3 of these were adopted from Crouch Amirbeaggi submissions.

From Page 387 to 394

PRE PACKS AND PRE-POSITIONED SALES

Directors may negotiate for a sale of the company, or parts of it, that is concluded either immediately before, or during, a formal insolvency process. Such sales could become more common as a result of advice given under the safe harbour defence.

This could create a process analogous to the current practice in the United Kingdom (box 14.2) of 'pre-packaged' sales (or 'pre-packs'), wherein preparatory work is done in advance but the sale is conducted at the beginning of a formal administration (before all creditors have been told about the business' failure).

ARITA noted their preference for 'pre-positioning' as distinct from pre-packs, which they argued should be reviewed by an insolvency practitioner:

> For a number of reasons, including independence … we do not consider that a UK pre-pack process would be suitable for Australia.
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> However, we see that there is a role for 'pre-positioning' in the Australian insolvency context. … [pre-positioning is] work done prior to a statutory insolvency appointment, with directors taking advantage of the safe harbour protections, subject to meeting the criteria for eligibility, to undertake an orderly wind down of the company's operations – that is a

> well-managed process where assets may be realised for market value in a non-distressed sale – prior to making a formal insolvency appointment. (2014a, p. 26)

Box 14.2 **Pre-packaged sales in the United Kingdom**

The ‘pre-pack’ process in the United Kingdom is not an intentional feature of the insolvency system created by any specific legislative reform. However, the United Kingdom’s Graham Review of pre-packs noted:

> Our working definition of pre-packing is: ‘Arranging the sale of all or part of a company’s undertaking before formal insolvency is entered, with the sale to be executed at or soon after the appointment of an administrator.’ (Graham 2014, p. 14)

Although they have been the subject of much policy focus, pre-packs are not common in the United Kingdom, making up just 3 per cent of insolvencies and less than 0.25 per cent of all exits (Graham 2014, p. 4).

A recent review of pre-packs in the United Kingdom noted concerns with the transparency of the process, and the lack of marketing of the sale of a business (lowering the sale price). The review also noted that pre-packs had benefits compared to more formal insolvency processes, notably that they are cheaper (in part due to lower court involvement), stand a better chance of preserving jobs and that deferred consideration (payment by purchasers occurring over time rather than at time of purchase) under pre-packs had a high rate of payment, to the benefit of existing creditors. Overall, the review did not recommend banning pre-packs, but rather some improvements to the existing process ‘all of which require action on the part of insolvency regulators and the insolvency profession rather than government’ (Graham 2014, p. 5).

ARITA noted their concerns relating to a lack of independent overview within the United Kingdom model:

> In the UK pre-packs are undertaken through the Administration process, whereby an administrator can be appointed by the company, the directors or by the holder of a qualifying floating charge out of court. Immediately after appointment, the administrator transfers the business for a pre-agreed price without the need for a creditors’ meeting to be called to consider the terms of the deal. The administrator then distributes the proceeds of sale. If there is no money for unsecured creditors, the administrator can immediately file for the dissolution of the company. If there are funds for the unsecured creditors, the administrator will usually be appointed as liquidator to make the distribution to unsecured creditors and then dissolve the company. In either situation, there is no independent insolvency practitioner undertaking a review of the steps taken. (2014a, p. 32)

To support their argument that the UK pre-pack system should not be directly adopted in Australia, ARITA noted the high failure rate and low benefits to unsecured creditors from ‘pre-packs’ in the United Kingdom:

> Approximately 65 per cent of all pre-packs resulted in sales to related parties. … often with deferred consideration – resulting in relatively high failure rate of the ‘newco’ (92 out of 310 connected sales in the UK study had failed within 36 months – 30 per cent; increasing the 37 per cent failure rate if there was also deferred consideration).
>
> The UK experience indicates that in 60 per cent of pre-packs there was no distribution to unsecured creditors, so therefore in the majority of pre-packs there is no benefit of the process to unsecured creditors. (2014a, p. 33)

ARITA’s pre-positioning option adapts the UK process but introduces elements of independence such that:

- Any advisor retained by the directors in the pre-positioning phase cannot subsequently be appointed in any formal insolvency administration.[1] This is consistent with the current and appropriate, independence requirements for insolvency practitioners in Australia.
- Any sales that occur in the pre-positioning phase must be for value and would be subject to review in any subsequent statutory insolvency administration.
- Any sale of assets undertaken during the statutory insolvency administration, where the terms of sale were negotiated in the pre-positioning phase, would be subject to review by the external administrator prior to being effectuated and the external administrator would be subject to the currently existing statutory and professional requirements regarding the sale of assets. (ARITA 2014a, p. 26)

The Commission shares ARITA's concerns regarding the lack of transparency in the UK system, and the potential impact this could have in facilitating 'phoenix' activity (chapter 15). However, the added independence from using a pre-positioning system would also introduce administrative costs and delays associated with the review process, add uncertainty into the process, and could drive down the business sale price. Overall, the Commission considers that the added independence, particularly on the part of the insolvency practitioner will be of particular value in cases involving related parties.[2]

However, not all related party transactions are necessarily designed to avoid liability. In some instances a related party may simply be the most appropriate purchaser available for the business — a director striking out on their own, a supplier, senior management team member or a large shareholder or creditor acquiring a business of interest to them.

Additionally, there is already a substantial body of regulation and process that must be complied with for a company (and its directors) to go ahead with a related party transaction. Current competition laws relating to mergers and acquisitions that could substantially lessen competition in a market would continue to apply. There are also general obligations for directors to not abuse their position to gain advantage for themselves or someone else (ss182 and 183 of the Act), the specific requirements for related party transactions (Chapter 2E of the Act), ASIC's Regulatory Guide 76: Related party transactions (ASIC 2011), case law and, for listed companies, Chapter 10 of the ASX listing rules.

The Commission is mindful of the potential for some transactions to become collateral damage from excessive regulation intended to target illegal activity. Rather than impose an additional level of regulation on related party transactions, the independent review and approval of a pre-positioned sale by an external administrator could be taken as evidence that a related party sale is of value to the company and falls within the 'arm's length' exception under s210

[1] The Commission notes that one exception would be a registered safe harbour adviser where the sale is a result of the safe harbour advice. As discussed above, in that instance the safe harbour adviser may continue with leave of the court.

[2] ASIC defines a 'related party transaction' as: 'any transaction through which a public company or registered managed investment scheme provides a financial benefit to a related party (such as a director, their spouse and certain other relatives). Almost by definition, related party transactions involve conflicts of interest because related parties are often in a position to influence the decision of whether the benefit is provided to them, and the terms of its provision' (ASIC 2011, p. 4).

of the Act. The external administrator would be obliged to evidence that they had checked the transaction against the existing regulatory requirements.

In the draft report, the Commission's recommended approach to pre-positioned sales was framed in terms of the safe harbour process, and delineated based on the involvement of related parties. Feedback from participants focused on the relationship with safe harbour, the balance between certainty of the transaction and independence of the administrator and the connection with related parties.

To be clear, the Commission's revised recommendation for pre-positioned sales interacts with, *but is not limited to,* the use of the safe harbour defence. The Commission envisages that pre-positioned sales may occur in the normal course of business, and need not involve a safe harbour adviser. For example, a sale may be negotiated for the company and effected prior to the appointment of an external administrator, or it could be negotiated prior to the appointment of an external administrator but effected post appointment.

Transactions in the first scenario would be governed by existing general directors' duties (ss180-4 of the Act). While administrators would not be required to specifically review such sales, there would still be scope for the sales to be challenged on the normal grounds (including unfair preferences (s588FA), uncommercial transactions (s588FB) and unreasonable director-related transactions (s588FDA), among others).

To improve certainty under the second scenario, but maintain protections, reliance on the safe harbour defence (and all its safeguards noted above) should be available to allow a pre-positioned sale of all or part of a business that occurs entirely before a formal insolvency appointment to go ahead, unhindered by any challenges for 'uncommercial' sales (that is, voidable transactions broadly defined). The presence of an experienced, registered and independent safe harbour adviser with documented advice should be sufficient to protect against wrongdoing, while at the same time improving certainty for parties to the sale.

In relation to sales effected *after* the appointment of an external administrator, several participants — including ARITA (sub. DR 53), DibbsBarker (2015) and McGrathNicol (sub. DR60) — focused on the need for transparency around the sale. Broadly, the Commission agrees and considers that requirements should be added to s439A of the Act (governing administrators providing information to creditors) to report on the reason for, and terms of the sale. The information to be provided could be based on the disclosure requirements within the United Kingdom's Statement of Insolvency Practice 16 (UK SIP 16, ABRP (UK) 2013) which governs pre-packaged sales.

DibbsBarkers (2015) and McGrathNicol (sub. DR60) also suggested that the administrator should be satisfied that appropriate marketing efforts were undertaken and that the sale achieved the best price reasonably obtainable in the circumstances.

While these are important considerations, to strike a balance between expedience and certainty for the sale of businesses, and independent review aimed at preventing illegitimate transactions, the Commission reiterates its preference for a 'two-tier' system for pre-positioned sales. The process would differ depending on whether any related parties were involved (a determination made by the administrator). This delineation allows for the level of investigation (and therefore cost and delay) to be more tailored to the level of risk involved.

If no related parties are involved, there is a presumption that the sale should go ahead, unless the administrator can prove that the sale was not for an amount within a reasonable range around prevailing market value (accounting for other reasons that the sale might be below market value such as the necessity for a quick sale, and a potentially limited pool of buyers), or the sale would unduly impinge on the performance of the administrator's duties.[3] In these instances, to reduce the cost and delay of review, the law should be amended to allow administrators to rely on the documented pre-appointment sale process as evidence of the marketing and sale price.

If any related parties are involved, there is no presumption favouring sale and the administrator's examination continues as normal, including consideration of whether the company has already complied with the body of related party regulations discussed above.

As with pre-appointment sales, the safe harbour defence should also be applied to voidable transactions (but does not obviate the need for a check of related party requirements, instead providing evidence that goes to the arm's length nature of transactions).

RECOMMENDATION 14.3

Provision should be made in the *Corporations Act 2001* (Cth) for 'pre-positioned' sales.

Where no related parties are involved, there should be a presumption of sale such that administrators can overturn sales only if they can prove that the sale was not for reasonable market value (in accordance with s420A of the Act), or if it would unduly impinge on the performance of the administrators' duties. Administrators or liquidators should be allowed to rely on the pre-appointment sale process as evidence.

If sales are to related parties, there is no presumption favouring sale and the administrator's or liquidator's examination of the sale process continues as normal. The administrator's review should include checks that the sale has met existing regulatory requirements for related party transactions.

In both cases, s439A of the Act should be amended to include requirements to disclose information of the sale to creditors.

Where the sale (whether given effect before or after the insolvency appointment) is the result of advice received under the safe harbour defence, that defence should also apply against voidable transactions actions from administrators or liquidators.

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3 DibbsBarker (sub. DR46, p. 5) provide an example of a sale where deferred consideration meant that the administrator was unable to carry on the business as a going concern and therefore needed to terminate the contract and sell the business for immediate payment.

PRE-POSITIONING [OR PREPACKS] FOR SMALL COMPANIES

The options for restructure discussed above involve professional expertise and therefore incur costs reflecting this — the typical (median) voluntary administration (including the execution of a DOCA) costs $60 000 (Wellard 2014).[4] In the UK, small businesses are the predominant users of the pre-pack system, with most pre-pack resulting in sale of the business for less than £100 000 (Crouch Amirbeaggi, sub.DR68, Graham 2014). While the Commission considers the regulatory safeguards around safe harbour are necessary, it acknowledges that the cost of an administrator or an experienced registered safe harbour adviser may be too high for some smaller businesses heading into financial difficulty. Such businesses may have little scope to restructure — they rely on a few assets and staff, and cannot separate elements to be sold off without damaging the 'core' business.

Crouch Amirbeaggi suggested an Australian hybrid model that could avoid these costs, assuage creditors' concerns, and present small to medium enterprises with a genuine option for restructure:

> I suggest that any Australian version prepacks require [that] liquidators assisting directors with a pre-pack … 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 confident that appropriate advertising and direct marketing of the available assets of a small insolvent business was undertaken. (sub. DR68, p. 7)

With the sale of a small business, as with small liquidations, proportionality in risk management is key for the level of regulation. In particular, any requirements for adequate marketing should not be onerous, but sufficient to ensure a good process has been conducted and prevent clear wrongdoing (such as phoenix activity, chapter 15). As with larger pre-positioned sales, small pre-positioned sales should also require disclosure to creditors, on grounds similar to those outlined in United Kingdom's Statement of Insolvency Practice 16 (UK SIP 16).

In the Commission's view, concerns about the independence of liquidators could be alleviated by leveraging off the recommended 'small liquidation' process (chapter 15).

Specifically, a small pre-positioned sale would involve the company initiating the process is the same manner as a small liquidation — applying to ASIC for a 'next cab off the rank' insolvency practitioner and providing proper books and records. Thereafter the practitioner would facilitate the small pre-positioned sale, generally in line with the processes in recommendation 14.3. One exception would be that the protections of s420A of the Act should be read in the context of, and applied proportionately to, the small business for sale. This would apply to determinations of the relevant market for the sale, the amount of advertising effort required and judging if a reasonable price had been received — there should be no

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4 Wellard (2014) examined a random sample of 72 executed COAs effectuated between 1 August 2012 and 231 July 2013. He found that the average cost of a voluntary administration was $54 670 and the average remuneration for a deed administrator (for a DOCA) was $97 141. The median remuneration for a voluntary administrator was $31 500, while for a deed administrator it was $28 772. Given the average is more heavily skewed by any expensive outliers, median remuneration figures are more likely to be representative of the costs faced by small businesses undergoing formal restructuring.

expectation that a small pre-positioned sale be the subject of an exhaustive national advertising campaign.

Such a process should provide an appropriate balance of an expedited (and therefore lower cost) sale with transparent processes conducted by independent practitioners — sufficiently protecting the interests of creditors and guarding against phoenix activity. This process could allow for a significantly smoother transition of assets (and employees) between businesses, than would requiring small companies to go through an expensive and time-consuming insolvency processes. Given its interaction with the Commission's proposed small liquidation process, it should only be implemented after the framework for small liquidations has begun operating.

As discussed in chapter 15, the Commission also considers that ASIC should publish a Regulatory Guide targeted at small businesses. A significant component of that guide should be directed at providing small business with a simple list of steps to follow in order to sell their business through a liquidator. This component should be modelled on the UK SIP 16. The production of such a guide will direct small businesses into the proper processes, improving overall compliance at a low cost.

RECOMMENDATION 14.4

The small liquidation process detailed in recommendation 15.1 should include provision for small pre-positioned sales, consistent with recommendation 14.3.

In the context of small businesses, the requirements of s420A of the *Corporations Act 2001* (Cth), and investigations of related parties, should be applied proportionately in relation to determining the relevant market for the sale, advertising effort and reasonable price.

14.2