O'BRIEN PALMER

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PRE-PACKS

DO THEY HAVE A PLACE IN AUSTRALIAN INSOLVENCY PRACTICE?

You may have noticed the occasional reference in the media to fraudulent phoenix activity and attempts by government agencies such as ASIC and the ATO to "crackdown" on serial offenders, particularly in the building and construction industry. Phoenix activity typically involves the transfer of the business assets of a company to a new entity, with creditors being left behind with no real prospect of payment.

There has been recent discussion in the profession about the distinguishing features of a phoenix and a bird of a different feather known as a "pre-pack". In the United Kingdom, pre-packs are a legitimate and accepted means to phoenix the business of a company. In Australia, there is no formal pre-pack procedure although variations of the process are often used by those who specialise in the area, particularly in the turnaround sphere. Where this occurs, the bona fides of the directors are often treated with scepticism. However in many instances, the transfer of assets from one company to a related entity may in fact be in the best interest of all stakeholders of the insolvent company.

In this newsletter, we explore phoenix activity and examine the pre-pack concept.

1.0 WHAT IS A PHOENIX COMPANY?

A phoenix company is usually considered to be one which is established to carry on the business of an insolvent company, using the assets and employing the staff of the insolvent company, but without accepting liability for its debts. In most cases, the members and directors of the phoenix company are the same or at least related to those of the insolvent company. The business rises from its burden of debt in a new corporate entity, using the same or a similar name, but the creditors of the insolvent company are left to recover what they can for the amounts owed to them through the liquidation process.

2.0 IS PHOENIX ACTIVITY FRAUDULENT?

Current legislation does not explicitly prohibit phoenix activity. However the process is one that can be easily abused with the result that the activity is often referred to as being fraudulent. Examples of phoenix activity generally considered to be fraudulent include;

(i) Transferring the business and/or assets of a company to a new entity for less than fair market value and/or on terms considered to be uncommercial.

(ii) Establishing a corporate structure for the express purpose of defeating creditors by incurring liabilities through that company whilst keeping assets safe in a related entity.

(iii) Deliberately incurring company debt immediately prior to the transfer of the business and/or its assets, without having any expectation that the company would be able to pay that debt.

In order to combat such activity, remedies are available within the Corporations Act which has a number of provisions dealing with breach of duties by directors as well as provisions designed to protect creditors in the event of insolvency. Proven breaches of these provisions can result in civil and or criminal penalties. Furthermore, the ATO is strengthening its powers using the Director Penalty Notice regime by providing disincentives to fraudulent phoenix activity by making directors personally liable in certain circumstances for their company's unreported unpaid superannuation and Pay As You Go withholding amounts.

The applicable provisions of the Corporations Act are as follows:

(a) If the phoenix sale of a company's business and assets is for less than fair market value or on terms considered to be uncommercial, then it may be challenged as an uncommercial transaction (section 588FB), as an unreasonable director-related transaction (section 588FDA), or as a transaction to defeat creditors (subsection 588FE(5)).
(b) If the sale is not in the best interest of the creditors, the directors may have breached their duties to the company and its creditors. These duties include the duty to act with care and diligence (section 180), to act in good faith and for a proper purpose (section 181) and to not improperly use their position or any information obtained because of their position to gain advantage for themselves or cause detriment to the company (sections 182 & 183). Should it be proven that the breach of any of these sections occurred with either deliberate intention or recklessness, then the breach may result in criminal liability for the director(s) (section 184).
(c) Pursuant to subsection 598(2), where the Court is satisfied that a person is guilty of fraud, negligence, breach of trust or duty and the company has suffered loss or damage as a result, the Court may make such orders as it thinks appropriate in relation to that person.
(d) If employees and employee entitlements are not handled correctly, the director risks committing the criminal offence of entering into a transaction with the intention of avoiding employee entitlements (section 596AB).
(e) If the directors do not prevent all unnecessary liabilities from being incurred once they realise a company may be insolvent, or likely to become insolvent, then they may have breached their duty to prevent insolvent trading (section 588G) and risk being held personally liable for those debts. If the failure to prevent liabilities from being incurred is proven to be dishonest, then the breach may constitute a criminal offence (section 588G(3)).

Proponents of pre-packs argue that if properly completed, directors will avoid breaching the above legislative provisions.

3.0 WHAT IS A PRE-PACK?

A pre-pack is a sale process through which the sale of the business and/or assets of an insolvent company is agreed prior to the appointment of an insolvency practitioner, whose task is to review the sale terms and if thought appropriate, ratify the sale. The model adopted in the United Kingdom has elements that would not be considered acceptable under Australian Law and practice. For example, in the United Kingdom, an insolvency practitioner will work with management to arrange the sale of the business and assets and after those arrangements have been made, he or she will then be formally appointed as Administrator. The conflict of interest is obvious. The pre-pack model, modified to suit the Australian environment, has three distinct steps, namely;

(i) Preparation

(a) The directors will have the business and assets of the Company valued by a reputable valuer. The sale of the Company's business and assets should be based on this valuation to ensure that fair market price is obtained.
(b) The directors should prevent all non essential debts from being incurred. In doing so, they will reduce any exposure to insolvent trading.

(ii) Execution

(c) The directors then arrange the sale of the company business and/or assets to another entity, for fair market value. A conditional contract would be executed together with an agreement to operate the business under licence. To prevent the appearance of any impropriety, the completion of the contract should be subject to ratification by an Administrator who would in the ordinary course seek creditor input.
(d) The employees of the Company would ordinarily be transferred to the new company, which will accept responsibility for their accrued entitlements.
(e) The business continues being operated by the new company.

(iii) Ratification

(a) The insolvent company then appoints an Administrator (or possibly a liquidator), who will investigate the sale, test the market if appropriate, and report to creditors. The expectation of management is that the sale will be ratified. If that transpires then the Administrator will complete the sale.
(b) If the sale is not ratified, then the contract will be rescinded. Responsibility for operating and selling the business would then revert to the Administrator.

Importantly, the insolvency practitioner to be appointed Administrator should not advise on the process. This ensures that following appointment, the Administrator can act and be seen to act, independently of those involved in the transaction. If for some reason, a sale was completed prior to appointment, then it is likely that the company would be wound up by way of a creditors' voluntary liquidation. In those circumstances and as in any winding up, the Liquidator would review the sale, and in the event it is found to be unreasonable, then he may, if commercial to do so, seek to overturn the sale under the voidable transactions provisions of the Act. The Liquidator would then realise the assets for the best price possible.

4.0 WHY PRE-PACK AND NOT ADMINISTRATION?

The voluntary administration regime was introduced in 1993, and was designed to provide a flexible mechanism for a company's affairs to be administered in such a way that maximises the chances of the company or its business remaining in existence or if that is not possible, results in a better return to creditors. It does this by imposing a moratorium on the company's creditors, giving an administrator time to investigate the company's affairs and consider a proposal for the company's debt to be compromised. The proposal can take many forms and if accepted by creditors, the company will then enter into a Deed of Company Arrangement ("DOCA").

As the legislative framework for flexible restructure is already in place, then why bother with a pre-pack sale? Critics of the voluntary administration process argue it is cumbersome, intrusive, costly and detrimental to the business. Proponents of pre-packs claim they offer a better chance for existing management to save their business and for creditors to maximise their return. They say pre-packs do this by:

(i) ensuring the continuation of the business in a new entity.
(ii) preserving the goodwill of the business and its suppliers & customers.
(iii) maximising the value of company business and assets.
(iv) avoiding a costly trade-on administration pending a sale.

In addition, creditors should have the comfort of knowing the sale is subject to review and ratification by an independent Administrator. However, there are other considerations that need to be taken into account, namely:

(a) The company will still have go through the administration process and bear the consequential costs of the Administrator possibly testing the market and dealing with enquiries which may extend to entering into negotiations for the sale of the business and assets.
(b) The appointment of an Administrator and the subsequent winding up of the company will still leave the directors exposed to potential claims under the Corporations Act; for example claims resulting from trading whilst insolvent. This means that the directors may still have to consider propounding a DOCA as part of the pre-pack process, further adding to the costs that might be incurred.
(c) The directors or owners of the entity acquiring the business and assets will need to arrange funding not only of the agreed purchase price but also ongoing working capital. In many instances buying the business and assets of a company will not be a practical option.

5.0 CONCLUSION

The debate surrounding phoenix activity continues, in which the cost to the community is contrasted with the efficiency and other benefits of the pre-pack process. Should directors who phoenix the business of their companies be held more accountable? Or should the interests of creditors in an increased commercial return supersede government concerns over the director's bona fides? The Government is considering further legislative amendments to inhibit deliberate, cyclic, fraudulent phoenix activity. In this regard you might be aware that earlier this year, the government introduced what is commonly called The Similar Names Bill, which sought to amend the Corporations Act to make a director of a failed company personally liable for its debts where the related entities had the same or similar names. We understand this Bill has made no progress but it is an indication of the Government's intentions.

Whilst the voluntary administration regime already provides a mechanism for the restructure of a company's business, it is often criticised. Proponents of pre-packs argue that a pre-pack sale of a company's business will in many instances deliver better results than can be achieved through a standard administration, and that sufficient safeguards already exist within the Corporations Act to protect creditors' interests. We consider that in certain circumstances, a formal prepack process may be more effective than voluntary administration. We also consider that the concept deserves to be further explored. This information memorandum is of necessity general in nature and its brevity could lead to misinterpretation and misunderstanding. No responsibility can be accepted for those who act on its contents without first consulting us and obtaining specific advice.

The harsh reality of commercial life is that from time to time businesses and individuals encounter financial difficulties. In many instances those difficulties are able to be overcome. The key is obtaining the right advice in a timely manner.

Our experienced and talented team is able to quickly assess the situation. The options are clearly explained and a course of action agreed upon. We approach each assignment with the aim of finding solutions that will result in the best possible outcome for all stakeholders. O'Brien Palmer offers a personalised service ensuring that your matter is given our full attention.

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Without obligation or cost, we are available for an initial consultation. Please contact:

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