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Dear Sirs

PRE-PACKS & PHOENIX CONDUCT

EXECUTIVE SUMMARY

If the process of legitimately saving a small business was clarified, the incidence of illegal phoenix conduct would be limited to only those parties who wish to engage in same.

Prepacks are the cheapest way to save a business from insolvency.
They are about 50% cheaper than a voluntary administration; and 25% cheaper than a normal liquidation.

The UK prepack framework is a 3 page regulatory guide. It is not a statutory framework.
If the Minister invited ASIC to do so, ASIC could very quickly issue an Australian version of the UK regulatory guide without any legislation.

The productivity commission recommended a regulatory guide on this issue be created but to date ASIC has declined to adopt this recommendation.

FEG should encourage ASIC produce Regulatory Guide.

COST SAVINGS

A voluntary administration costs on average $83K in Australia.

The company and business can be saved, via the compromise of creditor claims who generally get 5 cents in the dollar (via a deed of company arrangement).

Prepacks are the cheapest option to sell an insolvent business, because the insolvency practitioner can avoid all personal obligations of a trade on and instruct the director to undertake the hack work of a sale.

The insolvency practitioner can effectively act as a consultant and make the director and his staff do the work, rather than insolvency practitioners.

Pre-packs enable a director to legitimately move an insolvent business into a new company shell and start again without having to pay existing creditors.

The United Kingdom Government's enquiry into pre-packs reported 2 out of 3 pre-pack sales are to new shell companies set up by the existing company directors and about 60% defer consideration for the assets purchased.

PRE- PACK DEFINITION

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, who will finalise the sale as soon as possible after their appointment.*

Pre-packs are used in the following countries to help small companies restructure: the UK, Germany, France, the Netherlands, Belgium, Italy and the Czech Republic.

A variation of the pre-pack model is also used in the US. The most famous example was the General Motors restructure. A company called New GM Inc paid $50 billion for the assets from the insolvent GM Inc. The deal took 30 days to put together and was funded by the US Government. It's a great example of a successful phoenix saving about 200,000 jobs.

In 2014, a British Government review into pre-packs drew the following conclusions:

- About 25 per cent of all companies that go into administration in the UK each year (about 750 companies) implement a pre-pack;
- 96 per cent of pre-packs save jobs;
- Pre-packs are at least 50 per cent cheaper than a traditional administration;
- About 77 per cent of pre-pack sales in the UK are small companies (i.e. companies with fewer than 10 staff and a turnover of less than 1 million);
- The average purchase price of UK pre-pack sales in the UK is 54,000 (about $110,000).

For more details, see Graham Review into Pre-pack [hyperlink: https://www.gov.uk/government/publications/graham-review-into-pre-pack-College administration].

About 53 per cent of pre-pack sales in the UK use deferred consideration as a means to pay for assets subject to pre-packs. In two-thirds of these sales the new company will give security (a mortgage or security interest) to the insolvent old company to ensure the rights of its creditors are protected.

Here's an example of this type of pre-pack transaction:

A new company buys the assets from the insolvent old company. But the new company has no money to purchase the old company's assets, so it agrees to pay the market value of the assets in instalments over the next 12 months.

The new company then gives the old company a security interest (a mortgage or fixed floating charge) over its newly purchased assets, so they cannot be sold without the proceeds being paid to the old company. This protects the interests of the old company's creditors.

As the British Government report into pre-packs concluded:

> *"Old company creditors are not unduly harmed by the presence of deferred consideration in a pre-pack deal.*

1. PRE-PACK COST

The UK research suggest that 64 per cent of pre-pack sales are to related parties. The average sale price in the UK is $110,000. It follows that in Australia the most likely purchaser of a small business worth about $100,000 will be a related party, if that party is a motivated purchaser.

2. VOLUNTARY ADMINISTRATION OR PRE-PACK?

The voluntary administration (VA) framework is a world-class statutory framework, but the administrator's fees and trade-on costs are prohibitive for most small businesses to successfully use it to guide them out of financial distress.

In Australia only about 5 per cent of the 10,000 companies that enter into a formal insolvency administration each year will use this framework to successfully restructure.

Typically the lucky 5 per cent are large companies with enough money to pay the administrator's fees and trade-on costs.

In our experience, it is impossible for the majority of insolvent small companies to use the VA framework to restructure. The following background information supports this view.

Figures from a 2013 ARITA report:

- The average cost of a VA was $54,670
- The average cost of a deed of company arrangement $28,772
- Total professional fees came to $83,442
- The average dividend paid to creditors was 5.5 cents.

More from the ASIC Report 412 Insolvency Statistics to June 2014, Table 30:

- 80 per cent of all corporate failures have fewer than 25 creditors
- 75 per cent of all corporate failures owe less than $500,000 to creditors.

Various ASIC annual reports show 93 per cent of liquidations do not pay any dividend.

In short, in 75 per cent of the 10,000 companies that go broke each year, there is simply no money left. The mums and dads who own these 7500 SMEs don't even have the money to keep trading, let alone a spare $83,000 to pay an administrator.

Without at least $83,000 in cash or liquid assets, an insolvent business will usually be shut down and will not survive the voluntary administration process.

Voluntary administration remains a wonderful framework to restructure companies that have the resources to pay for administration costs. Everybody else should be restructured via a pre-pack or post liquidation sale of assets.

3. 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 %phoenixing+assets into a new cleanskin company. Pre-packs are the latest variation of this process.

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

THE UK'S PRE-PACK EXPERIENCE

About 50 to 100 pre-packs or legitimate phoenix sales are undertaken in the UK each month. The UKqs Government Insolvency Service (the counterpart to our AFSA) has stated:

> *"A pre-pack may offer the best chance for a business to be rescued, preserve goodwill and employment, maximise realisations and generally speed up the insolvency process."*

The insolvency regulatory bodies in the UK have issued a guidance note that sets out the basic principles and essential procedures insolvency practitioners must comply with when they undertake a pre-pack. (Thatqs right, the UK government has sanctioned pre-pack sales or legal phoenix sales and issued a guidance note to accountants and lawyers to assist them in undertaking pre-packs.)

Statement of Insolvency Practice 16 has been adopted by each of the UKqs professional bodies, including:

- The Association of Chartered Certified Accountants
- The Insolvency Practitioners Association
- The Institute of Chartered Accountants in England and Wales
- The Institute of Chartered Accountants in Ireland
- The Institute of Chartered Accountants of Scotland
- The Law Society
- The Law Society of Scotland.

The website of the UK Attorney General states:

> *"It is perfectly legal to form a new company from the remains of a failed company. Any director of a failed company can become a director of a new company."*

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	96%	65%
Secured creditor return	42%	28%
Average return (unsecured creditors)	1%	3%
Sale of assets to related party	64%	52%

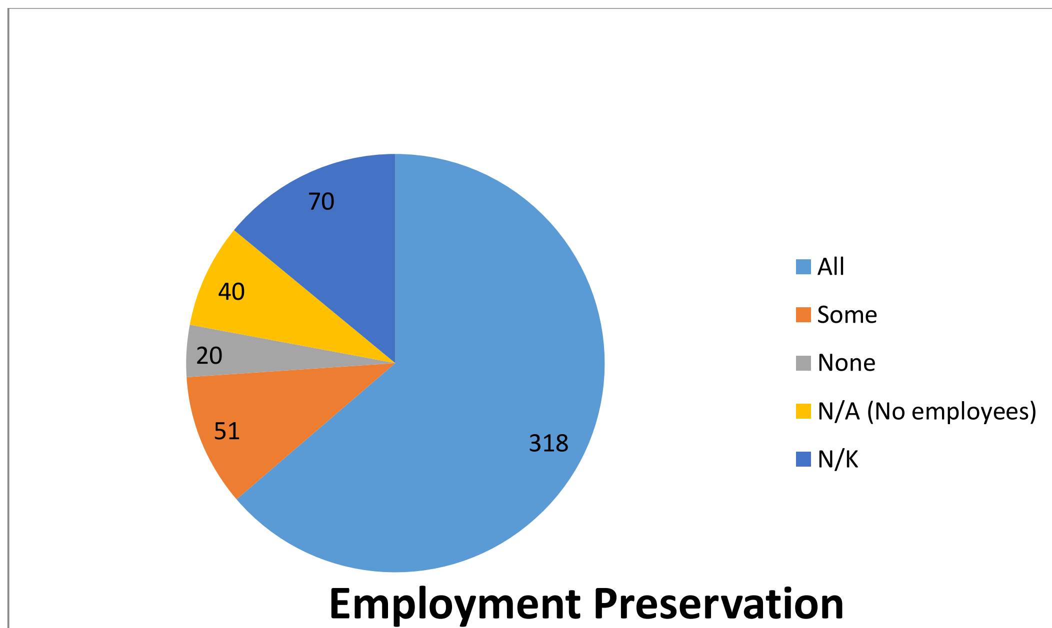
Source: Frisby SA %Preliminary analysis of pre-packed administrations+2007 https://www.r3.org.uk Amended for the Graham Review findings.

The key statistic from this table is this: 52 per cent of all insolvency sales by liquidators in the UK involve a sale of some assets to a related party.

PRE-PACKS SAVE JOBS

Statistics we obtained from ASIC on behalf of Senator Williams in 2010 showed that only 4 per cent of the 10,000 companies that go broke each year in Australia will complete their obligations under a deed of company arrangement (VA). That is, only 4 per cent of all insolvent companies will successfully restructure using the VA framework.

In the UK, by contrast, pre-packs have a 96 per cent success rate of preserving existing employee jobs, according to the UK Governments Graham Review. (See page 25 of the report; note only 20 of the 499 pre-packs in the sample failed to retain staff and most of these were cases where the business was shut down before a liquidator was engaged.)



If saving jobs is the yardstick for determining if insolvency laws help a business, thats a 4 per cent success rate for the Australian voluntary administration framework and a 4 per cent failure rate in the UKs pre-packs.

ONLY SMALL BUSINESSES USE PRE-PACKS

Page 26 of the UK Governments review into pre-packs indicates that the vast majority of pre-packs are used by companies that have less than $110,000 in assets.

RELATED PARTY PURCHASES

In the UK, about 64 per cent of all assets and businesses sold via a pre-pack are sales to related parties.

In Australia, there is no statutory prohibition on a director or a related party purchasing the business or assets of an insolvent company. In addition, there is a common misconception that any sale of a business to an existing director or related party is always an illegal %phoenix+.

4. ILLEGAL PHOENIX SALES

In ASIC’s 2010 Annual Report, phoenix trading was defined as the process:

> *“Where directors evade creditors by moving assets from an indebted company to another entity and then put the business into administration.”*

This process must be distinguished from the legally sound method of a liquidator selling the company’s assets to a new company or directors and their related parties.

In Australia it’s not unusual for the business of an insolvent company to be sold before liquidation. Unfortunately such sales are often conducted by shonky operators who intentionally seek to pay less than the market value for the business via illegal phoenix behaviour. It is generally understood that when a business is sold for less than market value before a liquidator is appointed, it is an illegal phoenix sale.

A 2012 report by the Fair Work Ombudsman into phoenix activity in Australia estimated the annual cost of phoenixing at between $1.78 billion and $3.19 billion. The report defines phoenix activity as:

> *“The deliberate and systematic liquidation of a corporate trading entity which occurs with the fraudulent or illegal intention to avoid tax and other liabilities, such as employee entitlements; and continue the operation and profit taking of the business through another trading entity.”*

It estimated that the annual cost of illegal phoenix restructures in Australia is:

- Up to $655 million for employees;
- Up to $1.93 billion for businesses, as a result of phoenix companies not paying for goods and services; and
- Around $600 million in unpaid tax.

ASIC, the ATO and dozen or so other government agencies now have task forces that seek to identify and prosecute parties for illegal phoenix sales.

5. PRODUCTIVITY COMMISSION

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:

> *“Crouch Amirbeaggi suggested an Australian hybrid model [for restructuring insolvent companies] that could avoids costs, assuage creditors’ concerns and presents 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 the 13 recommendations were directly adopted from the Crouch Amirbeaggi submissions.

Recommendation 15.7 invites ASIC to do what Crouch Amirbeaggi had solely lobbied for during the previous 5 years, that ASIC should introduce a Regulatory Guide on prepacks to assist small business owners who cannot afford to use a VA to save their insolvent small business.

Crouch Amirbeaggi was the first insolvency firm in the country to release ASIC statistics that show only 4 per cent of companies under a formal insolvency administration will successfully restructure by using the Voluntary Administration (±VAq) framework. Itqs an awful fact that only 4% of the 10,000 companies that get into trouble each year will be saved using a VA.

Crouch Amirbeaggi were also the first firm in the country to highlight this failure rate and compare it to the UK pre-packs process which have a 96% success rate of preserving existing employee jobs.

To discuss this matter, please contact the writer

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