NEWSLETTER

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ENHANCING SUCCESS

In this edition we look back at some cases of interest to insolvency practitioners over the last 12 months, discuss the regulatory regimes affecting pre-packs in the UK and Australia, and profile our newest partner, Radhika Kanhai.

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Is the time ripe to ban *ipso facto* clauses?

The Commonwealth government has recently announced a major policy agenda which includes changes to insolvency law in Australia. A bill has been introduced to begin this process and the banning of *ipso facto* clauses is a planned part of this policy in 2016 or 2017. We have been tracking the possibility of change in this area and this article addresses the significance of such clauses and whether the proposed legislative change is needed.

What are *ipso facto* clauses?

An *ipso facto* clause in a contract (from the Latin, "by the very act") allows a party to immediately terminate the contract without penalty if a specified event occurs. The most commonly encountered *ipso facto* clause is in relation to an insolvency event. If a party to a contract becomes bankrupt, has a liquidator, administrator or a receiver appointed and/or even has insolvency proceedings commenced against it, then the other party may terminate the contract if it contains an *ipso facto* clause.

In Australia there are currently no common law and only limited statutory provisions outlawing these clauses in a commercial context. For example, section 600F of the *Corporations Act*[1] limits the right of suppliers of essential services (electricity, gas, water or carriage services) to insist on payment as a condition of supply, but the use of *ipso facto* clauses is otherwise unrestricted. This can be contrasted with legislation in Canada and the United States which explicitly prohibit *ipso facto* insolvency event clauses.

The enforcement of an *ipso facto* insolvency event clause can significantly diminish a company's value. Especially if a significant portion of the company's value rests in its contracts, as opposed to its tangible assets. Self-evidently, such clauses inhibit the ability of the management of the business and an insolvency practitioner to sell or carry on the business as a going concern. In addition they add, perhaps unnecessarily, uncertainty to commercial contracts. Sound corporate contracts provide significant value to company stakeholders, including its creditors.

Much has been discussed about the growing emergence of pre-appointment restructuring in Australia, including the opposition of ARITA to "pre-packs". ASIC, the regulator in this area, has made little comment but remains diplomatic towards pre-packs. The enforceability of *ipso facto* clauses continues to be a barrier to effective restructuring of distressed businesses.

Comparison with United States and Canada

<u>Canada</u>

Canadian insolvency legislation provides a useful comparison to the Australian position. Like Australia, Canada has a mid-sized resource-based economy whose economic health is heavily dependent on the global market for commodities and natural resources. When currency fluctuation, resource and commodity volatility is high, as they have been from at least the second quarter of 2015 onwards, both Canada and Australia are hit particularly hard. This is evidenced by a

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[1] S. 600F *Corporations Act 2001* (Cth).

sizeable increase in corporate insolvencies in both countries during the June 2015 quarter contrasted with the June 2014 quarter.[2]

Under Canadian insolvency legislation, *ipso facto* clauses are prohibited and unenforceable. Section 34 of the *Companies' Creditors Arrangement* Act, provides that a person may not terminate, alter agreements or claim accelerated payment or forfeiture of the term under any agreement solely because insolvency proceedings were commenced or that the company is insolvent.[3]

The rationale provided by the Canadian legislature was that "parties should be entitled to rely on agreements regardless of an insolvency filing provided that they comply with all other terms of the agreement."[4]

United States

Commercial insolvencies in the United States are legislated by Chapter 11 of the *United States Bankruptcy Code*. Chapter 11 is more "corporate rehabilitation" orientated than its Australian counterpart. This is due in part to a strong prohibition on *ipso facto* clauses contained in section 365 of the *Bankruptcy Code* and from further provisions allowing the existing management of distressed companies to retain greater control of the company under the supervision of trustees. This is contrasted with Australia where management and control of the business is delegated to insolvency practitioners.

Tracking the indicators of the proposed change

Malcolm Turnbull has been on record as being in favour of law reform in relation to *ipso* facto clauses. Therefore it is no surprise that policy action has been taken soon after appointment as Prime Minister. The action was somewhat foreseeable given the Prime Minister's penchant for corporate welfare, combined with his stated distaste for Australia's so called "draconian insolvency laws" and Australia's uncertain economic outlook.

In September 2014, Malcolm Turnbull spoke at the Corporate Turnaround Conference. In that speech, Turnbull criticised Australia's "draconian insolvency laws", specifically *ipso facto* clauses:

> *Ipso facto clauses found in most commercial contracts (which essentially allow them to be terminated if a counterparty is insolvent or in administration) are real impediments, as they have been for many years. Both of these make corporate reorganisations or turnarounds more difficult than they need be.*
> *Propping up dying companies, a practise governments often find enticing, but I hope you have noticed that corporate welfare is not on the agenda of the Abbott Government, is almost always an error of judgement, and widely seen to be such.*[5]

The above comments suggest such a legislative change has been on the horizon since Turnbull took over. They also suggest that this is a key policy focus for the Prime Minister; one which he will be committed to see through.

What might an amendment look like?

In the September 2014 speech, Turnbull touched on what a proposed amendment to the *Corporations Act* might look like. His view was that Australian legislation might adopt particular provisions from the United States' Chapter 11

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[2] Australian Securities & Investments Commission. "Corporate insolvencies: June Quarter 2015" September 2015; Office of the Superintendent of Bankruptcy Canada. "Insolvency Statistics in Canada – June 2015".

[3] S. 34 *Companies' Creditors Arrangement Act* (R.S.C., 1985, c.C-36)

[4] Office of the Superintendent of Bankruptcy Canada. "Bill C-12: Clause by Clause Analysis – Clauses 71 -80 *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*". 24 March 2015. https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01986.html#a85

[5] Malcolm Turnbull. "NBN Co on the right track – but real risks remain. Speech to Corporate Turnaround Conference". 18 September 2014. http://www.malcolmturnbull.com.au/media/address-to-the-national-conference-on-corporate-turnarounds-transformation

Bankruptcy Code:

> *The characteristic of Chapter 11 that advocates have in mind is the opportunity it affords distressed companies to continue operating under existing management and with existing contracts protected from termination – but subject to oversight by a bankruptcy court. This greatly expands the scope for distressed companies to preserve goodwill, remain going concerns, and find solutions that minimise the losses suffered by all parties, not just creditors…*
>
> *On balance, the best answer is probably not a wholesale re-write of our current laws in this area, so much as provisions that identify and replicate the most beneficial elements of Chapter 11 by providing a safe harbour for companies seeking to reorganise. I'm on the public record several times over the years as supporting such changes.*[6]

Insolvency reform has been a topic raised as the government launches its National Innovation and Science Agenda. While it will be some time before any billaddressing *ipso facto* reform is introduced and we see precisely what changes will be made, the government are giving some indication of their plan for *ipso facto* clauses. The potential changes are part of a goal of the Turnbull government to improve the Australian business climate and reduce legislative red tape.

The policy does not indicate that *ipso facto* clauses will be scrapped altogether. However less definitive changes have been identified, such as making *ipso facto* clauses unenforceable if a company is undertaking a restructure. This may, for example, include changing the Corporations Act to prevent enforcement where a company is in voluntary administration or planning a deed of arrangement.

What happens next?

It is yet to be seen what form the proposed changes will make. The Insolvency Law Reform Bill 2015 containing the first measures of the new policy has been introduced and its success or failure will need to be monitored. It is also likely that this policy will be entwined with an upcoming election. Australia is also currently experiencing tumultuous economic conditions and is already seeing an increase in financially distressed companies. Indeed, more dramatic amendments to insolvency laws, bringing Australia closer to Chapter 11 Bankruptcy, in an attempt to improve corporate welfare and allow companies to restructure and rehabilitate may also be on the political agenda in the future.

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Extending time to register PPSA security interests under section 588FM of the Corporations Act 2001

***Re Appleyard Capital Pty Ltd; 123 Sweden AB v Appleyard Capital Pty Ltd* [2014] NSWSC 782**

Court: Supreme Court of New South Wales (Brereton J)

Background

On 9 February 2013, the plaintiff (**123 Sweden**) entered into a "binding term sheet" with the defendant (**Appleyard**) pursuant to which 123 Sweden agreed to lend Appleyard the sum of $320,000. The term sheet provided amongst other things, that Appleyard would register a "full floating charge" with ASIC for the benefit of 123 Sweden within 30 days from the signing of the term sheet.

On 14 February 2013, 123 Sweden advanced the funds to Appleyard and on 7 May 2013, Appleyard informed 123

[6] Ibid.

Sweden that it had "taken care of" its security interests as required under the agreement.

In February 2014, Appleyard informed 123 Sweden it was in financial difficulty and requested that 123 Sweden consider writing off its debt 'as a unsecured creditor'. 123 Sweden subsequently obtained legal advice as to whether its security interest had been registered and was told that Appleyard had not registered the security interest on the Personal Property Securities Register (**PPSR**) as required.

On 29 April 2014, 123 Sweden registered its interest on the PPSR. The Register also revealed that Appleyard had granted security interests to NAB (registered 11 December 2012) and CWS (registered 29 May 2013).

Given 123 Sweden's concerns that Appleyard may go into liquidation or administration within 6 months of registering its security interest on the PPSR, 123 Sweden applied for an order under section 588FM of the *Corporations Act* 2001 (**Act**) extending the time for registration to 29 April 2014. Without this order, if Appleyard was goes into liquidation or administration, or a deed of company arrangement executed, 123 Sweden's security interest would vest in Appleyard for the benefit of creditors generally and 123 Sweden would lose the benefit of its security.

Relevant Provisions

Section 588FL of the Act provides that where a company is being wound up, an administrator appointed or a deed of company arrangement executed (the "critical time") any PPSA security interest will vest in the company unless it is registered before the latest of:

(a) six months before the critical time;
(b) 20 business days after the security agreement came into force;
(c) if the security agreement came into force under a foreign law, 56 days after the security interest became enforceable; or
(d) a later time ordered by the Court under section 588FM of the Act.

Section 588FM(2) of the Act provides that the Court may make an order fixing a later time for registration where it is satisfied that:

(a) the failure to register the collateral by the required time was accidental or due to inadvertence or some other sufficient cause; or
(b) is not of such a nature as to prejudice the position of creditors or shareholders; or
(c) on other grounds, if it is just and equitable to grant relief.

As registration of 123 Sweden's security interest was not effected within the 20 business day period, if Appleyard was to go into liquidation or administration within 6 months after the actual date of registration, namely 29 April 2014, 123 Sweden's security interest would vest in Appleyard (for the benefit of creditors generally), unless the order extending time under section 588FM(2) was made.

In support of its application for an extension of time, 123 Sweden claimed its failure to register the collateral earlier was accidental, due to inadvertence or some other sufficient cause given it had not conducted business in Australia previously, was unaware of the requirement for registration under the *Personal Property Securities Act* 2009 (or the consequences for failing to register on time) and was told by Appleyard that registration had been attended to.

Decision

Brereton J was satisfied 123 Sweden's failure to register the collateral earlier was accidental or due to inadvertence or some other sufficient cause under section 588FM(2) of the Act. As such, the question was whether Brereton J should, as a matter of discretion, make the order sought by 123 Sweden and if so, on what terms.

In making this decision, Brereton J held that any extension of time under section 588FM would not affect the interests of secured creditors which had registered security interests prior to 123 Sweden's date of registration on 29 April 2014. In relation to the effect of such an order on unsecured creditors, Brereton J held that:

(a) whilst the prejudice to unsecured creditors is a relevant consideration, it is not merely established by showing that the dividend to unsecured creditors would be less if the security interest were not to vest in the company as the unsecured creditors may have been in no different a position had the security interest been registered on time. Rather, the prejudice that is relevant is the prejudice attributable to the delay in registration, rather than the order itself;

(b) the period of delay in effecting the registration is also relevant - the shorter the delay, the less likely the failure to register on time will have any impact; and

(c) the Court must have regard to the financial position of the company as at the time the application for an extension of time is made. If it is shown that the company was financially security, it is unlikely that a “critical day” will arise in the foreseeable future and so the grant of relief is unlikely to have any adverse impact.

Conversely, if the solvency of the company is not established or where it appears it may be insolvent, an order under section 588FM of the Act is likely to adversely impact the interests of unsecured creditors. However, as the purpose of section 588FM is to relieve a secured creditor from the consequences of failing to register its security in time, any detriment to unsecured creditors should not be the dominant consideration.

In this instance, Brereton J was of the view that there was a high degree of likelihood that Appleyard was insolvent or would go into liquidation or administration within 6 months. Despite this, His Honour found that there was no good reason why unsecured creditors should enjoy a windfall through the vesting of 123 Sweden’s security interest where:

(a) 123 Sweden advanced the funds to Appleyard on the basis it would be secured;

(b) 123 Sweden received assurances from Appleyard that registration of its security interest had been attended to;

(c) 123 Sweden was ignorant of the requirement for registration and effect of non-registration; and

(d) the subsistence of the registered NAB and CWS security interest during the period 123 Sweden’s interest remained unregistered is likely to have meant that unsecured creditors would have traded with Appleyard on the faith that 123 Sweden’s interest was unencumbered.

Impact

This decision highlights the need for secured creditors to ensure they promptly register their security interests on the PPSR. Otherwise, there is a risk that a secured creditor’s interest will vest in the company for the benefit of the creditors generally if the company subsequently goes into liquidation or administration.

This decision was followed by the decision of Brereton J in *Re Transurban CCT Pty Ltd (in its own capacity and as trustee of the Transurban CCT Trust)* [2014] NSWSC 1909. In that case, Brereton J considered an application made by the Road and Maritime Services for an order fixing a later date for registration under section 588FM of the Act as more than 20 business days had elapsed after the security agreement came into force. Prior to this, its security interests had been registered on the PPSR in time but contained alleged defects and accordingly fresh registrations were required, albeit outside time.

Brereton J was satisfied that there had been a failure to register earlier due to “inadvertence” within section 588FM(2) of the Act as there had been a bona fide attempt to register the security interests in time although those registrations contained alleged deficiencies.

Referring to the relevant considerations in the *Appleyard* decision, Brereton J held that even if there was some defect in the original registrations, a search of the of the PPSR would have disclosed such security interest and accordingly no party who dealt with the defendants could have believed no such interest existed or had not been registered. Further, the application under section 588FM had been made promptly after suspicion of the alleged defects. Accordingly, Brereton J made an order fixing a later time for registration in favour of Road and Maritime Services.

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Proportionality Prevails: Lessons from *Templeton v ASIC*

A recent unanimous decision from the Full Court of the Federal Court in *Templeton v ASIC* [2015] FCAFC 137 provides both optimism and useful guidance for insolvency practitioners in determining what constitutes reasonable remuneration. This case highlights the challenges faced by insolvency professionals in complex liquidations or receiverships. During proceedings involving insolvent companies, insolvency professionals are inevitably faced with balancing the tension between maximising the asset pool available to creditors and performing their required duties to a high standard.

In preceding years, the decisions emerging from the Australian federal and state courts have trended in the direction of reducing insolvency practitioners' fees and expenses in favour of preserving the asset pool available to creditors.[7] A tension has also emerged between an Industry standard in time based remuneration, and a judicial preference for charging a percentage of recovery in relation to SME jobs. This case represents a positive decision for insolvency practitioners in the sense that adhering to the principles of proportionality will not invariably result in reduced remuneration and/or expenses.

What is proportionality?

Proportionality is a multi-limbed doctrine. It refers to the idea that an insolvency practitioner's remuneration and expenses must be proportional to the quality, complexity and volume of the work completed, including the value and nature of property dealt with. For example, "*the time spent by an appropriately qualified and experienced practitioner in drafting a statement of claim should be proportionate to the amount in issue.*"[8]

In a similar vein, the remuneration sought must be proportional to the amount of money distributed to creditors.

Background Facts

The appellants were court-appointed receivers and managers who challenged a finding made by the primary judge reducing their approved remuneration and expenses. In 2010, ASIC obtained orders appointing receivers and managers of 21 unregistered managed investment schemes and 52 associated companies. The appointment orders provided the receivers would perform a variety of work including investigating alleged misconduct of the managed investment schemes, realising and subsequently distributing the scheme assets. The work to be performed was voluminous and of significant complexity. Under each appointment order, the receivers were:

> *…entitled to reasonable remuneration and reasonable costs and expenses properly incurred in the performance of their duties and the exercise of their powers as receivers and managers [of] the Property of [each Scheme], as may be fixed by the Court on the application of the Receivers, such sum to be calculated on the basis of the time reasonably spent by the [receivers and managers], their partners and staff, at the rates specified in Annexure B to [this Order].*

In 2013, the receivers filed an interlocutory application seeking approval for their remuneration, costs and expenses for the relevant period. The total amount claimed was $4,309,813.79, comprising of the receivers' remuneration, receivers' disbursements, legal fees and legal disbursements. In 2014, the taxing registrar fixed the receivers' remuneration, costs and expenses for the relevant period at $3,764,738.39. This reduced figure amounted to a significant overall discount of 12.65% with certain tasks being reduced by up to 20%.

Following the reduction in approved fees and expenses, the receivers filed an application in the Federal Court for review, seeking to challenge the Registrar's determination. The primary judge, Justice Gordon, dismissed the receivers' application and upheld the registrar's reduced remuneration. In upholding the reduced remuneration, Justice Gordon found that:

1 an excessive amount of time was spent on certain tasks;

2 some charge out rates were excessively high (up to $1200 p/h for a partner and $960 p/h for a senior associate);

3 senior staff spent excessive time completing administrative tasks when they should have been delegated to the

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[7] For example, *Re Korda; in the matter of Stockford Ltd* [2004] FCA 1682; *In the matter of AAA Financial Intelligence Ltd (In Liquidation)* [2014] NSWSC 1270; *In the matter of On Q Group Limited (In Liquidation)(Subject to Deed of Company Arrangement)* [2014] NSWSC 1428.

[8] Conlan as liquidator of Rowena Nominees Pty Ltd (in liquidation) v Adams (2008) 65 ACSR 521 at [47]. [Endorsed in *Templeton v ASIC* [2015] FCAFC 137].

appropriate level of seniority;

4 the receivers' remuneration "*appears large compared with these figures* [amount available for distribution].[9]." The asset pool contained a total of $10.9 million dollars, and the claimed remuneration was just over $4.3m. Justice Gordon found this claimed remuneration was disproportionately high; and

5 excessive delay by the receivers increased costs significantly.

The *Templeton* Appeal

The Full Court unanimously upheld the appeal against Justice Gordon's finding of reduced remuneration. The Full Court directed the matter to be reheard before another judge of the Federal Court who would rule on reasonable remuneration with the benefit of the Full Court's reasons. Some salient principles of the decision include:

Proportionality

In upholding the receivers' appeal, the Full Court unequivocally endorsed the doctrine of proportionality. In doing so, the Full Court held the primary judge had correctly reasoned that proportionality was a relevant factor in considering reasonable remuneration. However, the primary judge erred in her Honour's application of the proportionality principle. The Primary Judge failed to compare "like with like". The cost of completing a task must be proportional to the financial benefits resulting from the task.

In determining what would constitute a reasonable cost/benefit ratio, the Full Court provided that some work is sufficiently voluminous and difficult so as to warrant a high cost/benefit ratio. The figure provided by the Full Court was a ratio of 6/10. If a receiver spent $0.60 to receive a return of $1, then the proportionality test is satisfied if the expenditure was *necessary* to achieve the return.

Delay

With regards to delay, the Full Court held that delay in and of itself, even if deemed excessive, does not automatically warrant discounted remuneration. "For delay to justify a reduction, it had to be linked to increased or additional work that, absent delay, would not have been needed, or an increased level of inefficiency in the performance of the work…It is not good enough to say… that it is 'well- known that the effluxion of a long period of time results in an increase in costs.[10]" This finding is highly beneficial for insolvency professionals who, for a myriad of reasons, may face significant delays throughout the insolvency proceedings.

Practical Tips for Insolvency Professionals

We recommend that insolvency professionals afford substantial consideration to the utility of any task undertaken. Do the due diligence in assessing whether the proposed action is beneficial to the creditors, and if the time and expense in undertaking the task is proportional to the benefits obtained.

If there is any uncertainty or doubt as to whether a proposed action is beneficial, or necessary, insolvency professionals should not be afraid to seek directions from the court. Seeking appropriate directions may increase costs, but can still result in net savings to the pooled funds, if unnecessary work is determined by the court to be unnecessary.

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[9] *Templeton v ASIC* [2015] FCAFC 137 at [44].

[10] Ibid at [65].

Doing the Deal Before it All Goes Down

1 INTRODUCTION

There is scope within the Australian regulatory regime for distressed companies to engage in transactions which could see their businesses survive difficulties. Transactions may involve:

- completion of a sale of the assets of the business, either by management or by an externally appointed administrator; and/or
- a deed of company arrangement.

These 'workout' transactions are sometimes called 'pre-packs'.

Usually, the company carrying on the business is suffering financial stress and must act if the business is to survive. If it fails, the company will usually be wound up and unsecured creditors will receive little, if anything.

Pre-packs are designed to allow the business to survive, keep workers employed and provide a quicker, and a better return to its creditors.

Pre-packs have grown in popularity in the United Kingdom. However, take-up in Australia has been slow. This article highlights the regulatory regimes affecting pre-packs in the UK and Australia and other factors that affect how insolvency practitioners and management deal with distressed businesses.

2 UK REGULATORY REGIME

Since the passing of the *Enterprise Act 2002* (UK), pre-packs in the UK have become a popular tool for insolvency practitioners – in 2013 approximately 25 per cent of all administrations were pre-packaged.[11]

Although the UK legislation does not make any explicit mention of pre-packs, they have emerged as a legitimate means for insolvency practitioners to realise the objectives of their appointment as specified by the legislation. The objectives of external administration include:

a) rescuing the company as a going concern;[12] or

b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up;[13] or

c) realising property in order to make a distribution to one or more secured or preferential creditors[14].

Like Part 5.3A of the *Corporations Act 2001* (Cth) (**Corporations Act**), under the UK legislative regime, an administrator has broad functions[15], including the power to sell or dispose of the property of a corporation.[16]

In executing their powers, UK administrators are required to act as quickly and as efficiently as is reasonably practicable.[17]

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[11] Theresa Graham, *Graham Review Into Pre-Pack Administration* (2014) 6.

[12] *Insolvency Act 1986* (UK), Sch B1, s 3(1)(a).

[13] *Insolvency Act 1986* (UK), Sch B1, s 3(1)(b).

[14] *Insolvency Act 1986* (UK), Sch B1, s 3(1)(c).

[15] *Insolvency Act 1986* (UK), Sch B1,s 59(1).

[16] *Insolvency Act 1986* (UK), Sch 1, s 2.

[17] *Insolvency Act 1986* (UK), Sch B1, s 4.

The UK Government commissioned a review of pre-packs with a view to regulating their occurrence. The 'Graham Review into Pre-Pack Administration' identified a number of trends including:[18]

- Most pre-packs involved small businesses with a turnover less than £6.5 million and a median debt of £565,000;
- 60 per cent of the transactions were either not marketed by the administrator or marketing of the sale took place prior to administration;
- In 63 per cent of cases, the purchaser was a related party;
- In 91 per cent of cases, an independent valuation was obtained;
- In 60 per cent of cases, no distribution was made to unsecured creditors;
- In 76 per cent of cases the new company survived for longer than 3 years;
- Related party transactions had a failure rate of nearly twice the rate of unrelated party transactions.

Despite the prevalence of pre-pack insolvencies in the UK, there is still no legislative recognition of the practice: the insolvency profession self-regulates. The Statement of Insolvency Practice 16 (**SIP 16**) produced by the Institute of Chartered Accountants outlines best practice for pre-packs. Failure to adhere to SIP 16 may attract professional disciplinary proceedings.[19]

SIP 16 places a strong emphasis on the need for disclosure by an administrator to ensure all creditors can be satisfied that their interests have been considered. Information that should be disclosed includes:[20]

- The source of the administrator's initial introduction;
- The extent of the administrator's involvement prior to appointment;
- Any marketing activities conducted by the company and/or the administrator;
- Any valuations obtained (of the business and/or assets);
- Any alternative courses of action that were considered by the administrator;
- Why other courses of actions are/are not appropriate in the circumstances;
- Details of any requests made to funders to fund working capital requirements;
- Efforts made to consult with major creditors;
- The date of the transaction;
- The details of the assets involved and the nature of the transactions;
- The consideration for the transaction and the terms for payment of the consideration;
- The identity of the purchaser
- Any connection that exists between the purchaser and the directors/shareholders or secured creditors of the old company;

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[18] Theresa Graham, *Graham Review Into Pre-Pack Administration* (2014).

[19] The Institute of Chartered Accountants, *Pre-Packaged Sales in Administrations*, 'Statement of Insolvency Practice 16' (2009) 1.

[20] The Institute of Chartered Accountants, *Pre-Packaged Sales in Administrations*, 'Statement of Insolvency Practice 16' (2009) 4.

- The names of any directors or formed directors of the old company who are involved in the management or ownership of the purchaser

- Whether any directors have given any guarantees for amounts due from the old company to lenders and whether the same lenders will finance the new company;

- Any options, buy-back arrangements or similar conditions attached the contract of sale.

Administrators are advised to disclose all of the above information in their first notice to creditors announcing their appointment.[21]

3 AUSTRALIAN PRE-PACK OPTIONS

Under the Australian regulatory framework there is scope for distressed businesses to undertake pre-packaged insolvency transactions. Whilst some of the impetus behind a pre-packaged insolvency is lost when external parties are consulted, such options are worth considering.

3.1 Sale of assets by a company before appointment

A distressed company may seek to transfer its assets to a new company. The directors of the distressed company may then place it into administration or liquidation.

This style of transaction is sometimes labelled a "phoenix". However, if the commerciality of the transaction is sufficient and the transaction is undertaken within the law (i.e., the creditors were not disadvantaged by the transfer of the assets and a commercial sum was paid for them), there is potential for an outcome in the interests of all parties:

- the creditors receive more cents in the dollar than what they would have had no action been taken;

- the business survives; and

- the employees continue to be employed.

3.2 Section 437A Corporations Act

S437A of the Corporations Act empowers administrators to execute a pre-pack. An administrator may sell all or any part of the company's assets so long as the transaction satisfies the objects of the administration set out in s 425A of the *Corporations Act*.

In some circumstances, administrators have thought it prudent to seek judicial approval of early sales as illustrated below:

3.2.1 *Re Hancock*[22]

Administrators sought directions from the court on whether they would be justified in selling the business of the company to a related party without first seeking creditor approval. The terms of the offer put by the related party did not give any benefit to the general creditors of the company but did guarantee the accrued benefits of the company's employees and the position of secured creditors.

Windeyer AJ held that the administrator would be justified in selling the business to the related party without first obtaining creditor approval of the transaction. In making the judgment, his Honour stated that '[i]*t is not the function of the court to advise an administrator or a liquidator on what commercial decisions they should take*.'[23]

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[21] The Institute of Chartered Accountants, *Pre-Packaged Sales in Administrations*, 'Statement of Insolvency Practice 16' (2009) 4.

[22] *Re Hancock (as voluntary administrators of Advanced Medical Institute Pty Ltd)(Admin Apptd)* [2011] NSWSC 574.

[23] *Re Hancock (as voluntary administrators of Advanced Medical Institute Pty Ltd)(Admin Apptd)* [2011] NSWSC 574 [7].

3.2.2 *Global Food Equipment*[24]

In this case, the administrators applied to the court for an extension of the convening period so that they could facilitate the sale of the company's business and assets. The administrators had flagged to creditors their intention to sell the company's business at the first meeting of creditors and that they intended to move quickly to execute a sale. Importantly, the secured creditor supported the application by the administrators.

In granting the application, White J reiterated that an administrator has the power to sell all or part of a company's business, to do so would maximise the returns to creditors.[25]

His Honour went on to state that whilst it is not the responsibility of creditors to approve or disapprove of a proposed sale, creditors have a legitimate expectation that a second meeting will occur.[26] Nonetheless, his Honour deferred to the commercial experience of the administrators and recognised the fact that refusing the order might have the effect of discouraging purchasers and devaluing the business.

3.3 Deeds of Company Arrangement (**DOCA**)

A DOCA can be used as a mechanism to give effect to a pre-pack. A DOCA requires the creditors to approve the proposal being put to them. There are a number of issues concerning the use of a DOCA to effect a pre-pack:

3.3.1 there may be difficulties in obtaining the support and consent of the company's creditors, which may slow the process and cause the value of business to decrease[27];

3.3.2 the purchaser may be required to accept the trading risk of the business whilst the company remains in administration. However, the administrator may be personally liable for debts incurred during this period[28];

3.3.3 the insolvency practitioner owes a duty to the creditors for the conduct of the business during its administration, who may, therefore, require an indemnity from the purchaser.[29]

4 AUSTRALIAN REGULATORY REGIME

There are a number of factors that need to be taken into account when considering pre-packs:

4.1 Voidable Transactions

The provisions of the Corporations Act render certain transactions voidable on the following grounds:[30]

4.1.1 that the transaction gave an unfair preference to a creditor.,[31]; or

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[24] *In the matter of Global Food Equipment Pty Ltd (under administration); Carter v Global Food Equipment Pty Ltd* [2007] NSWSC 901.

[25] *In the matter of Global Food Equipment Pty Ltd (under administration); Carter v Global Food Equipment Pty Ltd* [2007] NSWSC 901 [13].

[26] *In the matter of Global Food Equipment Pty Ltd (under administration); Carter v Global Food Equipment Pty Ltd* [2007] NSWSC 901 [19].

[27] Emmanuel Poulos and Ayowande A McCunn, 'Pre-pack transactions in Australia' (2011) 19 *Insolvency Law Journal* 235, 254.

[28] Poulos and McCunn, above n14, 254.

[29] Poulos and McCunn, above n14, 254.

[30] *Corporations Act 2001* (Cth) s 588FE.

[31] *Corporations Act 2001* (Cth) s 588FA.

4.1.2 that the transaction was uncommercial;[32] and

when it was entered into the company was insolvent;[33]

4.2 Independence requirements

Administrators owe three separate duties of independence:

4.2.1 They must be and must be perceived to be, independent of the company, its directors, shareholders and creditors;[34]

4.2.2 They must act and must be perceived to act, impartially in discharge of the duties and responsibilities of their office;[35] and

4.2.3 They must ensure they do not place themselves in a position where there is, or might be, a conflict between their duties to creditors and their personal interests.[36]

An administrator may breach these duties if they have had some prior involvement with the company or accept a referral from a party who is interested in the transaction.

4.2.4 Walton Constructions[37]

In this case, the Full Court of the Federal Court found that administrators (and then liquidators) were in a position of apprehended bias or perceived lack of independence and impartiality in accepting an appointment that was referred to them by a regular referrer of work. This claim was brought against the administrators by the Australian Securities and Investments Commission.

This decision was made notwithstanding that the Court found that the Declarations of Relevant Relationships (**DIRRI**) given by the administrators complied with the statutory requirements under section 436DA of the Corporations Act. The DIRRI had disclosed a referral relationship through which the administrators were appointed and stated that this relationship did not affect their independence as administrators.

The Full Court determined that the test of an administrator's perceived independence is 'whether a fair minded observer *might* reasonably apprehend that the administrator *might* not bring an impartial mind to the resolution of the question the administrator is required to decide or investigate.' The Full Court found that the value of annual referrals would be regarded as significant by a fair-minder observer who would apprehend that an insolvency practitioner may not wish to put future referrals in jeopardy. Such a fair minded observer might apprehend that, because of the respondent's interest in not jeopardising future referral income, the administrators might not discharge their duties with independence and impartiality.

The test applied by the Full Court creates some uncertainty for insolvency practitioners. Even if the DIRRI requirements have been satisfied, insolvency practitioners must carefully consider whether to accept an appointment that has been referred to them, particularly where there is a need to investigate their referrer's actions, as this may create a perceived lack of independence.

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[32] *Corporations Act 2001* (Cth) s 588FB.

[33] *Corporations Act 2001* (Cth) s 588FC.

[34] *Bovis Lend Lease Pty Ltd v Wily* (2003) 45 ASCR 612 [123]-[141].

[35] *Bovis Lend Lease Pty Ltd v Wily* (2003) 45 ASCR 612 [123]-[141].

[36] *Bovis Lend Lease Pty Ltd v Wily* (2003) 45 ASCR 612 [123]-[141].

[37] *In the matter of Walton Constructions Pty Ltd; ASIC v Franklin (liquidator) & Ors [2014] FCAFC 85.*

4.3 Professional regulation

The ARITA Code of Practice prohibits an insolvency practitioner from accepting an appointment if he or she has had a professional engagement with a company during the previous two years.[38] Whilst a practitioner can provide general information and advice to directors about insolvency and its consequences, the same practitioner may not be minded to provide detailed advice on a pre-packaged insolvency or accept an appointment.

4.4 Respect for creditors

Although s437A of the Corporations Act allows an administrator to sell the business and assets of the company at any stage, there is an argument that administrators are weary of disenfranchising creditors by making significant decisions without creditor approval.[39]

The above factors include some of the regulatory matters that must be taken into account when considering a pre-packaged insolvency transaction.

5 CONCLUSION

Pre-packaged insolvencies can be a quick and cost-effective mechanism for distressed businesses to preserve value and protect creditor interests. Although the regulatory environment in Australia is not wholly conducive to pre-packaged insolvencies, there is scope for directors and insolvency practitioners to proceed with a pre-packaged transaction. Before any decision is made to undertake a pre-packaged insolvency transaction, it is critical that all possible ramifications of insolvency are assessed.

Author: John Hutchings - Chairman / Nick Amore – Senior Associate

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Introducing our newest partner Radhika Kanhai

Radhika commenced at the firm in August 2015 and now heads the Group. She has over 15 years' experience in complex court litigation and dispute resolution.

Her areas of significant expertise include corporate reconstruction and insolvencies, personal insolvencies, leasing disputes, contractual breaches, franchising and Corporations Act matters.

She has undertaken extensive accredited mediation training, resulting in particular expertise in the area of alternative dispute resolution through negotiation, mediation and conciliation processes. This enables Radhika to achieve the best practical and achievable outcomes for her clients.

She is currently President of Women in Insolvency and Restructuring Victoria and a professional member of the Australian Restructuring Insolvency & Turnaround Association.

Should you have any queries in relation to this newsletter or any other matters relating to the Reconstruction and Insolvency team, please contact partner and author, Jarrod Munro, j.munro@cornwalls.com.au and direct line +61 3 9608 2139.

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[38] ARITA, 'Code of Professional Practice' (2014) 19.

[39] Mark Wellard and Peter Walton, 'A comparative analysis of Anglo-Australian pre-packs: can the means be made to justify the ends?' (2012) 21 *International Insolvency Review* 143, 162.