THE GOOD, THE BAD AND THE UGLY: PRE-PACK ARRANGEMENTS AND PHOENIX ACTIVITY FOR SMEs

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There are a number of synonyms for phoenix activity, including asset stripping, phoenix trading, illegal phoenix, and phoenix arrangements. Unfortunately, there is no statutory definition for phoenix activity in the *Corporations Act 2001* (Cth) and so the terminology varies in judgments and articles.

Phoenix activity occurs when:

- A company (we'll call it 'Oldco') is insolvent; and then
- Oldco's business is transferred for inadequate consideration to a related entity (which we will call 'Newco'); but
- This transaction is detrimental to creditors, employees and other stakeholders; and
- This process may be repeated.

New research has sought to draw a distinction between what is a 'legal' phoenix and what is an 'illegal' phoenix. In their article 'Phoenix Activity and the Liability of the Advisor' (2014) 36 *Sydney Law Review* 471, Helen Anderson and Linda Haller argue that a distinguishing characteristic of 'illegal' phoenix activity is the intention of the parties to defraud creditors.

So why do directors and their professional advisers engage in phoenix activity? Phoenix activity occurs for a broad range of reasons, such as directors mismanaging cash flow resulting in unpaid taxes, businesses having unprofitable or unsustainable business models, or an attempt at disaster recovery following a crisis.

What is a pre-pack arrangement?

A pre-pack arrangement (also simply known as a pre-pack) has common elements to phoenix activity but it is distinguished by the process that creates the arrangement. A pre-pack arrangement occurs when:

- A company (Oldco) is insolvent; and then
- Oldco's business is transferred for commercial consideration to a related entity (Newco); and

Snapshot

- This article considers the line between legal pre-pack arrangements and illegal phoenix activity for insolvent small-to-medium sized enterprises (SMEs).
- Pre-packs (also called pre-positioned arrangements) now have the limited support of insolvency practitioners (through the Australian Restructuring Insolvency & Turnaround Association) but this area of the law is hindered by a lack of targeted legislation.
- The case of *ASIC v Franklin, (liquidator), in the matter of Walton Contructions Pty Ltd [2014] FCAFC 85* shows that a complex turnaround that involves a referral relationship between professional advisers and insolvency practitioners can be problematic.

- This transaction results in the optimal outcome for creditors, employees and other stakeholders.

The difference between phoenix activity and a pre-pack is that commercial consideration is provided by Newco for taking over the business assets of Oldco. There are two types of pre-packs and the second is considered in this article. The first pre-pack is where the asset transfer completes after Oldco is placed into insolvent administration (i.e. liquidation or voluntary administration) and the second type of pre-pack is where the asset transfer completes before Oldco is placed into insolvent administration.

The Australian Restructuring Insolvency & Turnaround Association (ARITA) has given conditional support to pre-packs in its 2014 paper 'A Platform for Recovery 2014 Dealing with Corporate Financial Distress in Australia: A Discussion Paper'. The paper refers to 'pre-positioning' and it advocates pre-positioning to enable viable (but insolvent) businesses to continue, and maximise returns to creditors via a sale of business negotiated prior to an external administration. However, ARITA also calls for legislation to make transfers of business assets of insolvent companies to related entities (as defined in s 9 of the *Corporations Act 2001*), illegal.

How can phoenix activity be attacked?

There are various legal actions that can be taken against the directors of a phoenix company (i.e. Oldco) such as insolvent trading actions by liquidators. However, liquidators are under no obligation to take this action if they have no funds in Oldco and no creditors or litigation funders are prepared to support them financially. The promoter's strategies underlying phoenix activity usually involve the appointment of 'friendly' liquidators who decide it is impractical or uncommercial to take action against the directors of *Oldco* and therefore, by default, the phoenix activity is ratified.

The principal avenues of attack against directors involved in phoenix activity are:

1. Taxation laws such as director penalty notices and estimates of tax liabilities;
2. Corporations laws such as the prohibition on insolvent trading, claw-back of uncommercial transactions and unreasonable director-related transactions and claims for breach of directors' duties.

The service of a director penalty notice (DPN) allows the Australian Taxation Office (ATO) to pierce the corporate veil and claim company tax debts against directors personally. After receiving a DPN, if the director recipient does not either discharge the liability or put the company into administration or liquidation within 21 days, the director becomes personally liable for the company tax debt.

The action that can be taken by the Australian Securities and Investments Commission (ASIC) or liquidators of phoenix companies includes:

1. Disqualification of directors of multiple corporate insolvencies;

2. Recovery of uncommercial transactions that pre-date a liquidation;
3. Recovery of unreasonable director-related transactions that pre-date a liquidation;
4. Recovery of losses for breaches of directors duties; and
5. Recovery of employee entitlements where an arrangement was entered into for the purpose of avoiding the payment of those entitlements.

Why go down the pre-positioning path rather than voluntary administration?

The voluntary administration process was created to protect the going-concern value of insolvent companies by creating a more flexible process with minimal court involvement.

The criticisms of voluntary administration include:

1. There may be significant damage to the goodwill of an insolvent business through lost contracts, staff resignations, supplier withdrawal and pressure upon directors;
2. The costs may be higher than what many SMEs can afford;
3. The complexity and risk of the process means there is no guarantee that the outcome will be commercial; and
4. The results may be suboptimal if creditors decide on a liquidation that results in a fire sale of the assets of the insolvent business.

Therefore it is reasonable for SMEs and their advisers to look at options outside of voluntary administration to protect their interests and ensure the goodwill value of a business is preserved. A pre-pack arrangement can create an optimal result when it preserves the goodwill of the business, saves jobs and give creditors a return equal to or greater than what they would have achieved in a voluntary administration or liquidation scenario.

The *Walton Construction* case

In *ASIC v Franklin (liquidator), in the matter of Walton Constructions Pty Ltd* [2014] FCAFC 85, the Court considered the question:

Should liquidators be removed for a perceived conflict of interest when they are duty bound to investigate a consulting firm that was a party to a pre-pack because that consulting firm had referred them $750,000 in professional work over the previous two years?

The case was about ASIC making an application to remove liquidators of two companies (i.e. Oldcos) on the basis that there was a lack of impartiality and also a breach of statute because the liquidators failed to disclose a potential conflict of interest to creditors, as required by s 436DA of the *Corporations Act 2001*.

In Australia, liquidators are under a duty not only to be actually independent but ostensibly independent (i.e. they must be seen to be independent by creditors) (*National Australia Bank v Market Holdings* (2001) 37 ACSR 629).

An insolvency practitioner may also be disqualified from an appointment if there was a previous 'substantial involvement' with an insolvent company (*Commonwealth v Irving* (1996) 64 FCR 291 at 296).

The background

ASIC was dissatisfied with the circumstances of the appointment of the voluntary administrators (who would later become liquidators) over two trading companies, Walton Construction Pty Ltd (Oldco 1) and Walton Construction (Qld) Pty Ltd (Oldco 2). Both Oldco 1 and Oldco 2 were related entities with the same sole director (Mr Walton) and each company retained a consulting firm, Mawson Group, to advise on the restructuring transaction. Walton Construction was in the construction business, and when Oldco 1 and Oldco 2 appointed voluntary administrators there were construction projects with estimated gross future revenue of $56 million to be completed as well as other assets of the companies available. The Court noted that Oldco 1 owed Oldco 2 a debt of $18.9 million as it was being supported by Oldco 2.

The transaction

Before the appointment of voluntary administrators the following series of transactions were entered into between Oldco 1 and Oldco 2 and Lewton Asset Services Pty Ltd (Newco 1) and Tantallon Constructions Pty Ltd (Newco 2):

- Asset sale agreements for the acquisition of the business assets including construction contracts in consideration for the assumption of some of each of Oldco's liabilities;
- The debt of $18.9 million owed by Oldco 1 to Newco 2 was assigned for $30,000 to a QHT Investments Pty Ltd.

It is worth noting that Newco 1, Newco 2 and QHT Investments Pty Ltd were related parties to the Mawson Group's directors and shareholders and Mr Walton had no apparent ownership interest in these companies.

The decision

Two pertinent allegations raised by ASIC were:

- The assignment of the inter-company loan of $18.9million for a stated consideration of $30,000 was a phoenix transaction because it had the effect of shifting assets to the detriment of creditors; and
- An impartial observer would have a reasonable apprehension of bias because the liquidators were referred $750,000 in work over a two-year period by the Mawson Group before they were appointed to Oldco 1 and Oldco 2.

The Court made no finding about the first allegation but it agreed with the second allegation regarding the apprehension of bias. White J stated at [95]: 'At the very least, the fair-minded observer might apprehend that LDD [the Liquidators] may not wish to put their continued receipt of income of these proportions in jeopardy. That is especially so in the circumstance that the "referral relationship" had been formed only recently and that the number of referrals had been slowly increasing.'

Takeaways for advisers

ASIC looked unfavourably upon the following elements of the transaction:

- Opaque relationships between parties;
- Forgiveness of a debt;
- Complex transactions; and
- Transactions that appeared to lack a commercial purpose.

The takeaway from this case is that insolvency practitioners put themselves at risk of removal if they are involved in pre-pack arrangements, even if they have no direct involvement but are involved through referral relationships with the promoters or professional advisers. On the other hand, the incoming liquidators will have the difficult job of evaluating the transactions.

There have been no legal actions at the date of this article against Mr Walton or Mawson Group (and its related parties) and there was no final order that the transactions, overall, were uncommercial. It may be that the Mawson Group and Mr Walton entered into a valid pre-pack and that the ire of ASIC was unfounded. The takeaway for directors is that the quality of the professional advisors that they engage to assist them with a pre-pack is critical to minimise downside risk. **LSJ**