CORPORATE INSOLVENCY

Voluntary Administration: Is the Process a Success?

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TRANSCRIPT

Thanks for those kind words Andrew and I will be able to give you a rest now.

I think it is fair to say that I support Philip Crawford's comments relating to the issue which is raised in this ASC report and I will be fleshing those out in a bit more detail. I would love very much to be up here talking about URA – I think Philip does a very good job marketing that job for us. But while his paper was on "The Good, the Bad and the Ugly", I have the task to draw the curtain back a bit further in relation to the events and the findings of this study that was completed and published in April. Before I do that though, I would like to give you some background to set the scene for the statistical analysis about where voluntary administration is going.

I will divide the talk up into two parts – firstly some anecdotal observations and then a more detailed analysis of this research paper.

Before I get to that though, I think it is important to consider what is going on with Patrick. I do not propose to talk about that in great detail other than to say that certainly community awareness of voluntary administrators has risen dramatically and what the process is about. Andrew Boxall, when I sent him the slide, asked me to identify which one was the administrator here! All that I can say to that is "trust us, we are here to help you".

In relation to the anecdotal observations, these are some national statistics taken out from the ASC database. You are all probably aware that Part 5.3A was introduced at the end of June 1993. If we just briefly have a look at these statistics over here we can see overall the number of administrations has remained relatively static between 1993/94 and 1996/97. What has happened though is that there has been a significant change in the mix of where external appointments are occurring and particularly we have seen a dramatic rise in the use of voluntary administrations. As the economy has picked up also we have seen a drop-off in receivership appointments and also a significant reduction in court appointments.

There have been just under 5,400 voluntary administrations initiated in the first four years across Australia. As at August 1996, about half of these voluntary administrations converted into deeds of company arrangement. There have been a number of studies initiated, and one of the first studies was one conducted by the Society of Accountants in August 1996. On the face of it the findings indicated voluntary administration is a raging success. It indicated that of a sample of only 500 voluntary administrations about 90% of the deeds of company arrangement succeeded,

the balance went into liquidation. I would point out that it is a relatively small sample and it was a practitioner-based response to the study. So it may well be that the responses that were received by the ASCPA were the best 500 voluntary administrations rather than a more representative sample.

In the context of this particular survey what was happening in terms of appointment and what were the reasons, you can see very little in this particular sample, very few secured creditor appointments. In terms of what are the drivers for the voluntary administration – winding up petitions, also pressure from the Tax Department here on directors is consistent with our experience across our practice in Australia, basically the administration process is associated with small companies. In this case in this study, turnovers of less than $1,000,000 and 90% of the voluntary administrations involving less than 50 employees. So to a large extent, pursuant to this particular study, basically voluntary administrations have been involved at the smaller end of town so to speak.

In relation to the ASC study, the statistics that Philip gave, I think there was a typo there. Over the four years in New South Wales there have in fact been 1,890 companies that have entered into voluntary administration and as Philip's slide indicated earlier, 38% of those entered a deed, 59% went into creditors' voluntary liquidation, and of the 38% that entered the deed, 17% went into liquidation. So overall, about 76% ultimately ended up in liquidation.

In terms of the actual ASC research paper, one of the key issues that was driving this particular study was basically complaints being received by the ASC. And they were not isolated examples. They were persistent examples of, and allegations about, the conduct of administrators. It was first brought to the ICAA's attention in 1996 at one of the discussion groups and at that particular time we were advised that there were these persistent allegations about the conduct of administrators in particular, steps being taken to have pre-arranged sales of assets particularly to associates for inadequate consideration, failure to properly inquire relating to preference payments, apparent breaches by company officers in the circumstances of directors' loan accounts, an inability or a failure to inform creditors when it was clear that there was no practical arrangement, where no practical arrangement was possible and therefore liquidation being the only option, and basically attempts and arrangements being entered into whereby the creditors were just being offered a few cents in the dollar ostensibly to keep them happy. Also, and this is one of the points that Philip highlighted earlier, an almost total non-compliance by the administrators of lodging section 438D reports which is similar to the section 533 report that liquidators are required to lodge, whereby the administrators have to provide opinions as to whether or not officers have been guilty of offences – negligence, default, breach of duty or trust.

I think it is worth just spending a little bit of time also to expand upon some of the other complaints that have been received because as legal practitioners you may well come across these when you are advising clients. There were constant allegations about the appointment by directors of friendly administrators who would basically work in the interests of the directors and shareholders rather than promote the interests of the creditors. Appointment of administrators to frustrate the efforts of a creditor to have a liquidator appointed through an application to the court. Circumstances where the voluntary administration process was being used to avoid an investigation into related party transactions or potential breaches of the law by directors, as I have already mentioned. Use of the voluntary administration process in a variety of ways as a stalling tactic – in some cases adjourning the first meeting of creditors (the five day meeting) and then having subsequent adjournments such that at the end of the day the creditors just throw their hands up and walk away. Complaints about the fees and costs of administrators being too high, that there had been no limit or no control imposed on administrators. The section being used to basically offer creditors a minimal return in return for releases for the directors. And basically a failure by administrators to administer the arrangements that had been put in place pursuant to deeds of company arrangement. So on the face of it, it is really not a pretty picture.

In relation to the actual study the sample involved 55 actual administrations and 16 practitioners in the Sydney metropolitan area. The actual study was conducted by Barry Cook who was formerly an insolvency partner at one of the big six firms and Barry has had over twenty years experience in the industry.

In terms of the actual criteria, the key issues are outlined there. In terms of the variety of outcomes, they looked at a range of different outcomes for the voluntary administrations. For example, either going into liquidation situations where deeds had been terminated and then going into liquidation, or where voluntary administration proceeded to deeds, or other circumstances where the voluntary administration was terminated and the companies handed back to directors. So the criteria is fairly straightforward there. They also looked at high profile issues, high profile companies, and there was particular attention paid apparently to the building industry.

In terms of the actual aims of the research, there were two specific objectives: what was happening with compliance (section 5.3A); and what was happening to the terms of the deeds of company arrangements that had been approved by creditors. Also there were a couple of other objectives that they sought to identify, ultimately leading to whether or not there should be suggestions for changing the existing practice. What the ASC did, they actually issued section 30 notices against the administrators or to the administrators, and they had in most circumstances the files delivered up to their offices where they conducted the review or the study and then that was followed up by interviews with the particular practitioners.

Turning now to findings. Compliance with section 5.3A – the big issue revolves around the voluntary administration proposal reports which on any assessment of this particular study have been basically hopelessly inadequate.

Just to refresh your memory, the three basic requirements of the proposal report is firstly that the administrator has to report on the affairs and the financial circumstances of the company. You then have to form an opinion and state an opinion as to three possible courses of action – firstly, whether the administration should come to an end and whether the company should go back to the directors; secondly, or alternatively, whether the company should enter a deed of company arrangement; and thirdly, whether the company should go into liquidation. In this report if a deed of company arrangement is proposed there is required to be a statement of the details of the proposed deed.

Coming back to the proposal reports, some of the findings clearly are failure to give any opinion at all in some cases that were examined. The statement relating to the deed of company arrangement lacks sufficient detail so that creditors were unable to actually form a clear view and be able to form an opinion themselves on what is in their best interest. That third particular point there – relating to companies failing to disclose that they were trading subject to a deed of company arrangement – this is very simply that they were just not putting on their documentation where there were trade-on deeds of company arrangements, that they were under a deed of company arrangement. And the study found that this in certain circumstances appeared to be deliberate.

There was also in a minority of cases evidence of the administrators drawing remuneration without approval and also attempts to use licensing agreements to circumvent the personal liability issue. What they were doing is that they would be going to directors and saying "we will license the business back to you, you can be responsible for all the profits and losses while we propound the proposal". In some cases that I have been involved in, not under voluntary administration but involved with selling businesses where we have entered into licence agreements, because people that we were ultimately going to sell the business to were checked out financially from a business expertise point of view and there was mileage and benefit in entering those arrangements. But in this particular case or in the cases examined here, what was happening is that they were just entering into the licence agreements, in some cases all the trading was still being conducted through the administrator's bank accounts, nobody knew what was going on, the creditors were being hit a second time around, so it was really turning into a bit of a shemozzle.

There was also, as far as the proposal reports were concemed, an inadequate assessment and compliance with various statutory issues.

In terms of compliance with the deed of company arrangement terms, I will not spend a lot of time on this. Philip has already mentioned the principal issue, and the most important thing here is that deeds were being entered into which had specific terms and conditions relating to the receipt of

money, relating to how the deeds were to be monitored, the obligations on the administrator and also what steps were to be taken in the event of default – and basically they were not being adhered to. That is really what the bottom line is there.

In more than 50% of the cases that were examined of the files inspected, the administrators had failed to comply with the terms relating to the receipt of money. Now clearly they were not acting in the interests of the stakeholders who had agreed a particular course of action which was ultimately documented in the deed.

Other findings very briefly. This whole issue of vote rigging I would have to say is pretty distasteful, but it is going on, it has gone on, it is still going on. It is overall pretty unsatisfactory. The ASC is very concerned with this and ultimately as you are aware the law provides mechanisms to challenge the results of a vote, but this is court driven and ultimately the creditors that speak to me in these circumstances, unless they are particularly incensed, they just see good money being thrown after bad in terms of having to go to court and try and get the issue tossed out or changed.

Just the bottom point there which is worth considering. There was an analysis of how the secured creditors were voting. There was no evidence at all of any abuse associated with that, and the general findings were that there was no need for change.

Just some other observations there. As I have pointed out, there were other areas of substantial non-compliance. Where the deeds were being documented, these were significantly different to what the creditors had approved or what they thought they had approved. In seven out of thirty-seven cases observed, the deed did not reflect the arrangement with creditors. In six out of nine cases where there had been a variation to the deed, the administrator had failed to adhere to the law or properly inform creditors – pretty basic stuff. As I have already said, there were circumstances where there was non-compliance. Non-disclosure with the deed of company arrangement where creditors were not being informed, it was not being put on the documentation. And only in two situations – there were sixteen practitioners reviewed and only in two cases had these practitioners lodged the required section 438D investigation reports.

Very quickly then, there was some further evidence of other issues relating to failure to lodge notices of appointment, failure to enforce the terms of the deed of company arrangement, this whole issue of canvassing for special proxies to ensure a particular voting outcome, and also amending or framing resolutions such that the voting ultimately would reflect the outcome that a particular administrator was seeking.

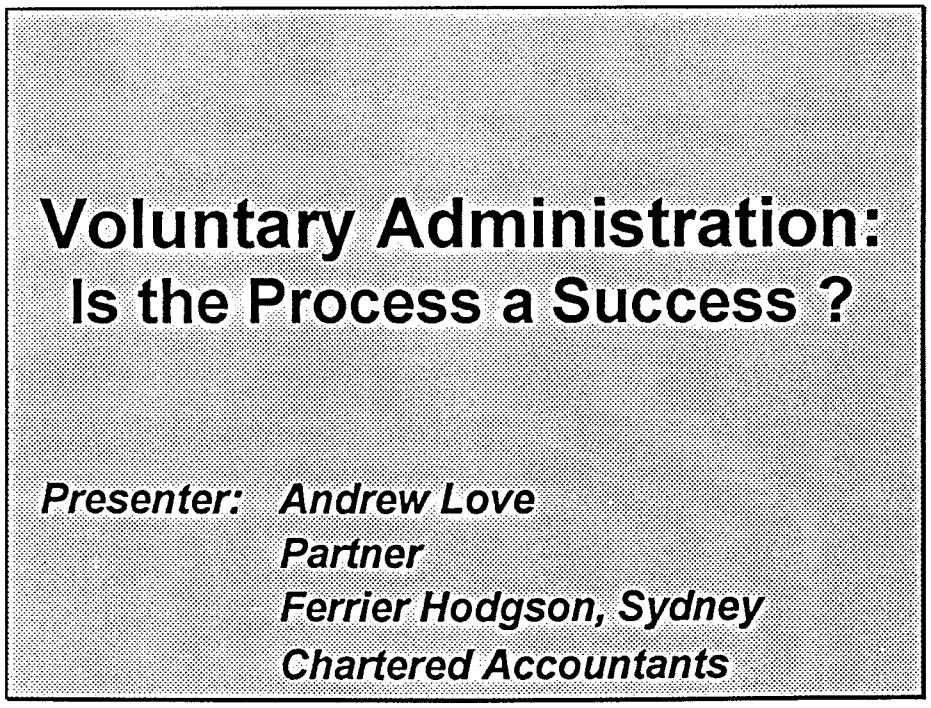
I will just move on to conclude in terms of suggestions for improvement. The ultimate outcome of the study indicated that there should be a checklist prepared for the voluntary administration's proposal report – I do not have a problem with that, I think that is fairly standard, nobody should have anything to hide. The ASC noted that the actual standard of reports did improve over time when they were monitoring these particular practitioners. They also state that there should be a statement setting out the terms, or they recommend that there should be a statement setting out the terms, the proposed deed of company arrangement, that this should be specified. They believe that the prescribed agenda items for the five day meeting, which is the ability to remove the administrator if you like, the ability to appoint a committee of inspection, this should all be adhered to prior to any adjournment. They also believe that administrators should be required to obtain signed reports as to affairs, and not all practitioners are receiving these as has already been outlined. The whole issue of licensing agreements should be clarified and there should be a banning of this unless it is in genuine arm's length circumstances.

They proposed by way of recommendation the consideration of an independent chairman to overcome these proposed voting abuses. And in circumstances where a voluntary administrator is appointed in an outstanding winding up application, they are seeking to recommend to prohibit this. They believe that ultimately the petitioning creditors should retain their priority and the liquidator should determine whether a voluntary administration is in the best interests of the company.

Finally, there is also an issue that has been developing where you have related party transactions, where you have claims by other companies, debts of the directors where they vote at the meeting and then they stand back for dividend purposes. What they are proposing or what has been happening here is that once the creditors' claims are extinguished by operation of the deed, these other related party claims are still remaining as liabilities against the company. So technically what is happening is that the deed has been completed and you have got a company that is still insolvent.

There is hope at the end of the day. Although what I have painted in terms of the outcome of this particular study is alarming, I would have to say it is unsatisfactory, but overall I think the voluntary administration process is working. Certainly in the administrations that we have been involved with, we believe it is a very successful mechanism for restructuring not only small companies, but also large companies.

What is the ASC intending to do? Philip has already outlined a few of those things. Ultimately I believe the steps they are going to take, if the education process is not satisfactorily embraced by practitioners, and if the policy statements and practice notes that they prepare are not adhered to, ultimately we will end up with further legislation restricting our powers which would, I think, be very unfortunate. It is up to the accountancy profession to get their act together.

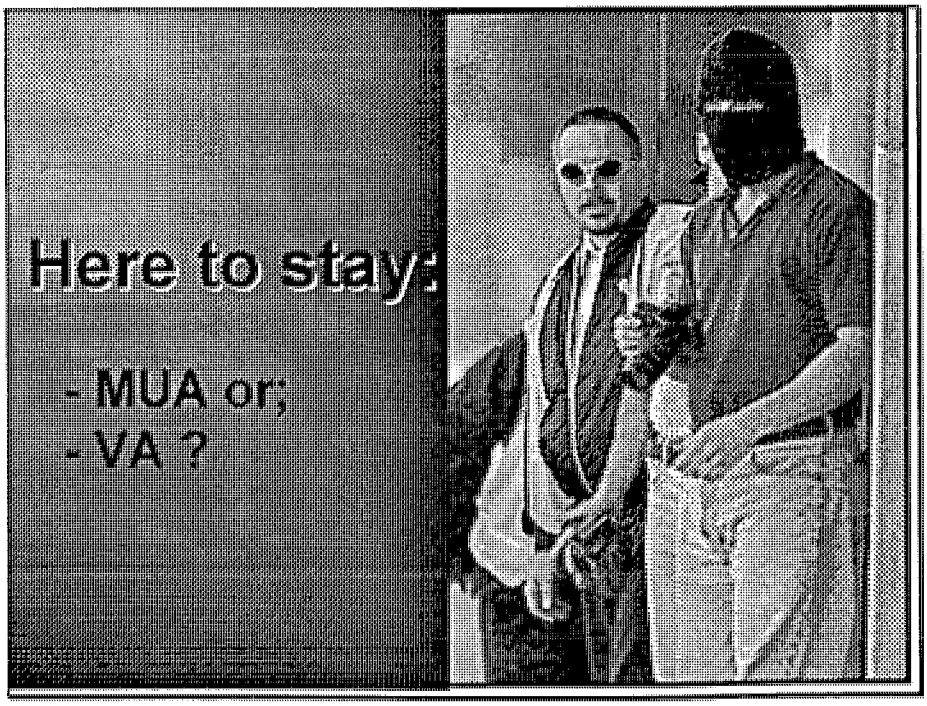


PART A: Anecdotal Observations

PART B: ASC Research Paper - A Study of Voluntary Administrations in NSW

Acknowledgement: Much of the information contained in this presentation is based on:

- ASC Research Paper 98/01: A Study of Voluntary Administrations in New South Wales; and
- A VA Survey conducted by the ASCPA's Centre for Excellence for Insolvency & Reconstruction (Aug 1996)



PART A

Anecdotal Observations

Voluntary Administrations to date

Period	C/Vol.	Court	R/ship	VA	Total
1993/4	12%	56%	15%	17%	4,401
1994/5	10%	47%	12%	31%	4,102
1995/6	11%	41%	11%	37%	4,345
1996/7	11%	38%	10%	41%	4,236

Voluntary Administrations to date

- In the first 4 years 5,392 VA's initiated
- Approximately 50% of VA's convert to DCA (at Aug 1996)
- Based on an ASCPA survey (at Aug 1996) of 500 VA's:
  - 90% of DCA's succeed. The balance reverted to liquidation
  - Average unsecured dividends:-
    - DCA 30c/$
    - Alternate Liquidation Scenario 7c/$

Voluntary Administrations to date

- Based on an ASCPA survey (at Aug 1996) of 500 VA's:
  - Secured Creditors appointed 2% of VA's
  - 12% of VA's followed wind up petitions
  - 2/3 of VA's involve companies with annual turnover less than $1m
  - 90% of VA's involved less than 50 employees
  - 15% of VA's followed ATO issuing directors with personal liability notices - s.220AOE ITAA

PART B

ASC Research Paper: A Study of Voluntary Administrations in NSW

Why the ASC Conducted Research

- March 1996 - ASC comment to an IPAA Discussion Group:

  "...complaints that the VA process was being abused had become too persistent to be ignored."

- April 1998 - ASC publishes Research Paper 98/01: *A Study of Voluntary Administrations in NSW*

The Basis of the Research

- Examined 55 VA's involving 16 practitioners practising in Sydney metropolitan area.
- Principal selection criteria:
  - practitioners who had conducted most VA's;
  - variety of outcomes;
  - complaints and/or known court actions;
  - absence of s.438D reports;
  - other unusual features.

Aims of Research

- Assess compliance with:
  - Part 5.3A of the Law;
  - terms of DCA's approved by creditors.
- Identify:
  - the purposes for which Part 5.3A is being used;
  - other issues of operation of Part 5.3A or the activities of insolvency practitioners;
  - suggestions for change of practice.

Findings of the Research

- Compliance with Part 5.3A:
  - Improved over time
  - some VA proposal reports were inadequate:-
    - Failed to give an opinion;
    - Statement about DCA lacked sufficient detail;
    - Some company's failed to disclose trading subject to DCA: appeared deliberate;
    - VA's drawing remuneration without approval;
    - VA's using licence agreements to avoid liability;
    - Statutory Issues

Findings of the Research

- Compliance with DCA terms:
  - Instances of practitioners failing to enforce DCA terms include:-
    - Timely receipt of monies;
    - Monitoring and reporting; and
    - Timely action on default
  - Research recognised the need for a degree of flexibility and professional judgement in administering a DCA

Other Findings

- Instances of "controlled" voting by related parties and the use of proxies
- Casting votes had been exercised by VA's to advance their own interests
- DCA's were being recommended where there was little chance of success
- The VA process was being used to frustrate outstanding wind up applications
- Voting by secured creditors showed no evidence of abuse: no need for change

Summary of Observations

- Areas of substantial non-compliance:
  - practitioners preparing DCA's that are not reflective of creditor approved proposals
  - practitioners failing to adhere with Law when varying DCA's
  - companies failing to disclose trading subject to DCA
  - practitioners failing to report offences to ASC

Summary of Observations

- Evidence of:
  - practitioners failing to lodge notice and advertise appointment on a timely basis
  - practitioners failing to prepare and lodge minutes of committee meetings
  - practitioners failing to enforce DCA terms
  - canvassing for special proxies to ensure voting outcomes. Consider an independent chairman
  - some resolutions framed to enable the VA (as holder of general proxies) to vote for resolutions affecting their appointment and/or fees

Summary of Observations

- Other Observations:
  - amendments to the prescribed provisions in some cases are not in the best interests of creditors
  - administrators should not recommend DCA's that have little or no chance of success
  - Part 5.3A is being used in some instances as an automatic route to liquidation
  - secured creditors had not abused their "new" voting rights

Suggestions for Improvement

- A checklist of matters to be addressed in a VA's proposal report would ensure more reliable information is provided to creditors
- The statement setting out the terms of a proposed DCA should be specified
- Prescribed agenda items should be dealt with at the first meeting prior to any adjournment
- Resolutions approving remuneration should not be open ended

Suggestions for Improvement

- Directors should be required to provide a signed RATA to the VA
- Clarify the use of licensing agreements. Consider banning use other than genuine arms length circumstances
- Consider the need of an independent chairman to overcome any perceived abuse
- Prohibit the appointment of a VA when outstanding wind up application, unless Court approval of VA

Suggestions for Improvement

- Companies should be required to remedy any insolvency upon termination of a DCA, ie write-off or capitalise related party loans
- VA/DCA's should be required to lodge accounts of receipts and payments with ASC
- Companies that have changed their name should be required to display previous name for six months

But There is Hope

- The ASC Research Paper concludes that:
  - the VA process is worthwhile; and
  - gives companies an opportunity for rehabilitation
- In response to the research, the ASC intends:
  - undertaking a practitioner education programme in conjunction with the IPAA;
  - preparing Policy Statements or Practice Notes as guides for practitioners;
  - making appropriate recommendations for Law reform

CORPORATE INSOLVENCY

QUESTIONS AND ANSWERS

Question – Peter Hedge (Coopers & Lybrand, Brisbane):

I was wondering if the panel has any ideas as to how our banking clients may be reacting to the ASC reports now that Philip has confirmed everything we have known for the last two years?

Response – Philip Crawford (Speaker):

The banking clients that we have, have all received copies of this report. They are digesting it at the moment. I think what they are doing is they are taking a view on the practitioners who they are coming up against in situations where they have got secured debts and they are taking a specific view on how they will act – which I think is the right course of action. We have also advised them where they see any overt abuses that they really should report them to the ASC and to the ICAA – that is really the only course of action. The ASC is really getting behind this. I know internally that they are devoting a significant number of resources at the moment and gearing up disciplinary proceedings against a number of parties, which should happen frankly.

Response – Andrew Love (Speaker):

Peter, I think the ASC report identified two problems. One is competence and one is a perceived lack of independence. And I still think that we need some legislation to go back to the same as the appointment of liquidators – you take the top one off the list, you have to be suitably qualified, you have to be a member of the list and it is up to the directors to justify the appointment of a voluntary administrator as opposed to liquidation. And that will clear out, I think, the two major problems.

Question – Michael Riches (Minter Ellison, Sydney):

A process at the moment is a lot of secured creditors are taking charges over less than the whole of the assets of companies and obviously that exposes them to a risk on a voluntary administration of being subject to the moratorium. I was wondering whether you were aware of any judicial consideration of what constituted substantially the whole of the assets of a company?

Response – Philip Crawford (Speaker):

We have not run across it recently Michael because in most cases, I must say, that I have acted, we have had security over substantially the whole of the assets. But I have had some experience recently with lease creditors where lease creditors have, in effect, been the owners of most of the property of the company, which has created some difficulty. And for the most part in my experience they have sat back and watched the administrator to see how he has performed and waited until the creditors decided whether to enter into a deed of company arrangement or not,

and depending on how that goes and how the future trading operation of the company looks, then decide what course of action they will take for themselves, but certainly not be bound by any deed of company arrangement by voting at the meeting.