



KordaMentha

# Grouping of Entities in the Event of Insolvency

The KordaMentha Research Unit  
Paper 401

Level 24, 333 Collins Street  
GPO Box 2985  
MELBOURNE VIC 3001  
Telephone: 03 8623 3333

## Table of Contents

1.	Introduction .....	1
2.	Background .....	2
3.	Recommendation .....	3
4.	Case studies .....	6



## 1. Introduction

Under existing legislation it is possible for creditors and employees of some companies in an insolvent group to receive no dividend, whilst creditors and employees of other group companies are paid out in full and the surplus is then available to shareholders.

The recent controversies regarding holding companies not being legally responsible for the liabilities of their subsidiaries and the unsatisfactory position of the Ansett creditors require a considered response and changes to the Corporations Act.

We believe that consideration should be given to requiring, by law in the event of insolvency, that all assets of companies within a group should be available to meet all of the liabilities of the companies within the group. This concept is commonly referred to as “pooling”. However, legislation should also enable a company within a group to elect to “opt out” such that its assets and liabilities will not be pooled, eg special purpose non recourse debt funded companies.

The KordaMentha Research Unit has prepared this paper to develop and expand on our recommendation as outlined in Paper 305: Rehabilitating Large and Complex Enterprises in Financial Difficulty.

**The concept of limited liability is clearly a bedrock of corporate law and it is critical that any amendments to current legislation do not interfere with the proper economic role of limited liability entities. In particular, it is critical the cost of capital is not adversely impacted.** We believe the “opt out” arrangements, if constructed appropriately, may allow these broad aims to be achieved without materially impacting upon the commercial function of corporations. In order to achieve this it will be necessary to involve all stakeholders (and in particular debt and equity providers) in a broad consultative process prior to any legislative changes.



## 2. Background

The Corporations Act requires that each company within a group be treated as a separate legal entity. Accordingly each company must have its own constitution, its own board of directors, its own registered office, and its own company secretary and prepare financial statements which must be audited.

However, the practical reality is often somewhat different. In many instances companies in a group are run as a single entity. The group treasury function is located in one company with all cash within the group being swept into the bank accounts of one company; the human resources function is typically centralised; brands are developed for the group, not for individual companies; there is only one CEO, one CFO; all or most employees are employed by one or just a few entities within the group.

Currently a holding company and its wholly-owned subsidiaries may apply to the Australian Securities and Investments Commission for relief from the requirement for the wholly-owned subsidiaries to prepare and lodge audited financial statements. The wholly-owned subsidiaries and the holding company have to enter into a deed of cross guarantee whereby each company guarantees the debts of each other company within the group. The deed of cross guarantee makes the group of companies that are parties to the deed akin to a single legal entity, particularly in the event of insolvency, but there are still practical problems, e.g. priority creditors.

The introduction of the tax consolidation regime makes each company within the group liable for the taxation debts of all other companies within the group, unless a group company “opts out” by entering into a tax sharing agreement. This achieves “pooling” for all tax liabilities in the event of insolvency. It also results in the Commonwealth (in respect of taxation liabilities) now having an advantage over all other creditors.



### 3. KordaMentha Proposal

We believe that consideration should be given to requiring, by law in the event of insolvency, that all assets of companies within a group should be available to meet all of the liabilities of the companies within the group. This concept is commonly referred to as “pooling”. However, legislation should also enable a company within a group to elect to “opt out” such that its assets and liabilities will not be pooled, eg special purpose non recourse debt funded companies.

We recognise in certain specific and limited circumstances groups set up special purpose vehicles such that the company’s assets and liabilities are kept separate from the rest of the group’s assets and liabilities, ie in non recourse debt arrangements. Provided the creditors of this special purpose vehicle are adequately on notice then we recognise it is entirely appropriate that the assets and liabilities of this company not be pooled.

We recommend that all holding companies should be required to notify ASIC of any of its subsidiary companies which will not be pooled. In effect we recommend rather than group companies “opting in” for “pooling” by and entering into cross deeds of guarantees, the process be reversed to an “opt out” arrangement. There must be a practical difference between the current “opt in” arrangements and the proposed “opt out” arrangements. Whilst all groups will have the ability to “opt out”, we believe the positive step required to achieve this (board resolution or shareholder approval), and the public disclosure required as a result, should restrict “opt outs” to bona fide circumstances.

We recognise that there are a number of ancillary matters which must be addressed prior to the commencement of a consultative process.

#### **Definition of a corporate group**

In the context of this proposal, we would define a corporate group in accordance with the provisions of AASB 1042. The standard follows Sections 46, 47 and 50AA of the Corporations Act and is concerned with practical control (ie. a less than 50% shareholder may be deemed to control a company, and vice versa). Creditors and potential creditors of a company can then focus on the reported consolidated position of the entity, rather than the individual financial statements of the subsidiaries that are part of the group.

#### **Liability of partly owned subsidiaries**

Whilst we believe partly owned subsidiaries should be included within the definition of group as per AASB 1042, a consensus will need to be reached in respect of the extent of the liability of a partly owned subsidiary. Should it be liable for 100% of the group’s liabilities, or should such liability be restricted in recognition of its less than 100% ownership? Under Section 588V of the Corporations Act a holding company is already 100% liable for the liabilities of a partly owned subsidiary in the event of the subsidiary trading whilst insolvent. It would therefore be consistent that the liability arrangements under this proposal should also be similarly unrestricted. An alternative would be for the degree of liability to depend upon the circumstances of each case rather than through the application of a fixed method of



calculation. However, whilst liability would be imposed by statute under such a proposal, liability would require the determination of the Court on a case by case basis.

### **Restrictions on “opt out” mechanism**

Consideration should be given to whether the “opt out” mechanism is available to all companies within a group, or whether the right should be restricted to a special class of group companies such as special purpose vehicles with non-recourse debt arrangements. For the proposal to have any meaningful impact, the incidence of “opt outs” would have to be restricted to bona fide circumstances and should not lead to wholesale “opt outs”. If “opt outs” are to be restricted through legislative limitations, then it will be imperative that broad consultation is undertaken to establish, and provide allowances for, all bona fide reasons for “opt outs”. We believe a more workable approach would be to educate all stakeholders (and in particular creditors and employees) as to the purposes of the proposal and encourage a corporate climate in which wholesale “opt out” becomes commercially unacceptable and unviable.

### **Notification of “opt out”**

There already exists an obligation to advise ASIC of changes to closed groups. It should therefore be relatively straightforward to establish a public ASIC register in respect of entities that have “opted out”. Each group could be assigned a unique registered number and the individual corporate returns for each group entity be amended to provide for the group number to be inserted on all documents and forms.

### **Rights of creditors in respect of “opt out” decisions**

A primary purpose of the proposal is to improve the position of creditors as a whole and address those circumstances in which groups of similar classes creditors inequitably receive differing distributions through the insolvency process. An “opt out” by a group entity could advantage or disadvantage the creditors of the individual entity, and advantage or disadvantage the remaining creditors of the group, depending upon the assets and liabilities of the “opting out” entity. Given these circumstances, should the creditors have any voice in the “opt out” decision? Subject to wider consultation, we believe not. There would be an inherent conflict between a decision which is in the best interests of the shareholders, and what creditors perceive to be in their best interests. It should also be considered that directors currently have the authority to grant fixed and floating charges and enter in Deeds of Cross Guarantee. Both actions have the propensity to disadvantage creditors but neither requires creditor approval.

### **Relation Back Period**

In the absence of any restrictions, the “opt out” mechanism could theoretically be used by a solvent group to immunize itself from insolvent subsidiaries by deciding that one or more insolvent group companies should opt out to protect the overall insolvency of the remaining group companies. The proposal is intended to prevent such actions. Whilst we do not believe creditor approval of the opt out decision is appropriate, we believe a more workable solution to protecting creditors’ rights is through the provision of a relation back period. ASIC PF 26 presently provides that a company leaving a group subject to a Deed of Cross Guarantee is excused from group liabilities only if a group entity is not wound up by Court



or through a Creditors' Voluntary Liquidation, within six months of the date of the withdrawal from the group. We believe similar Relation Back Provisions should exist in respect of entities that "opt out" of the proposed grouping arrangements, although the trigger should be extended to include the appointment of Administrators or Receivers.

### **Transition Arrangements**

The proposal will clearly have a significant impact on existing group company structures. Appropriate transitional arrangements are outside the scope of this paper, but will require broad consultation with all stakeholders.



## 4. Case studies

We detail below some practical examples as to why we have recommended changes to the Corporations Act in respect of grouping of entities in the event of insolvency.

### **Ansett**

- Forty-two companies in the Ansett group were placed into administration. Substantial legal and professional fees were spent analysing which assets/liabilities belonged to which companies. This was an unnecessary expense resulting in a reduced return to creditors.
- There are obvious clear advantages of having the same administrators in all 42 companies when it comes to co-ordination of the group and maximising asset realisations (imagine 42 different administrators in 42 companies?). However, inevitably, the administrators are left with potential conflicts between the companies, eg cost allocations and creditor disputes between companies. The conflicts then have to be dealt with either by the Court, the creditors or other independent persons. Another unnecessary complication and expense.
- In Ansett there was a separate special purpose vehicle (Ansett Aviation Equipment) for financing aircraft. The banking syndicates to Ansett had separate guarantees from this company. Accordingly, under our recommendation, if Ansett Aviation Equipment had “opted out” by notifying the ASIC, this company’s assets would not be made available to all group creditors.
- It was clear in Ansett that, other than sophisticated financial creditors, all other creditors believed they dealt with “Ansett”, they did not differentiate between Ansett companies. Particularly, the employees thought they were employed by “Ansett” and did not differentiate between Ansett companies. In Ansett, some employees of certain companies will receive more than other employees in other companies. This is hardly fair or equitable.
- The Ansett group had one treasury function and effectively centrally banked. The individual companies within the group had no direct access to cash. A strict running of each company on an individual basis may have seen certain businesses close down due to lack of cash.
- The Ansett Administrators entered into a very complex arrangement with Air New Zealand providing \$150m to the administrators. The Ansett Administrators also entered into complicated arrangements with the Commonwealth to ensure employee entitlements to a community standard were paid promptly. Both these agreements required “pooling” to arrive at a fair and equitable outcome for stakeholders (because of the deficiencies in the Corporations Act). Notwithstanding the agreements there are still many issues outstanding relating to the pooling of assets and liabilities and it has proven costly to resolve these issues.



### **Stockford Accounting Group**

- The Stockford Accounting group of companies was structured so that the listed holding company and four of its first tier subsidiaries were the subject of a class order and had entered into a deed of cross guarantee, so that in many respects we, as Administrators, could treat these companies as a single legal entity. This saved significant costs and time.
- However, we were also appointed over another 79 companies in the group which were not subject to the class order. While selling the various accounting and wealth management practices we experienced issues in identifying which of the 79 companies held assets of the various accounting practices. Frequently the employees of an accounting practice were employed by one legal entity, while the assets, goodwill and liabilities of the accounting practice were in a number of other companies. Accordingly, we made a number of the Stockford legal entities signatories to the sale agreements to ensure that we were able to transfer the assets, goodwill, employees and relevant liabilities to the purchaser. There are ongoing issues as to exactly which assets and liabilities belong to each company that may ultimately lead to litigation.
- If our recommendation was adopted, all the assets and liabilities would have been grouped and the issues identified above would have been automatically resolved. Furthermore, no issues would have been raised on allocating the purchase price proceeds among the Stockford companies which were parties to the Business Sale agreements.
- In our opinion it was fair and equitable that all Stockford's group assets should be available to all of the group's creditors and that they should rank equally.

### **Confidential Group Company**

- During a receivership we encountered a situation where the directors of the group companies had structured the group so that the employees of the business were employed by one company, a separate company owned the business including debtors, with the group's real estate holdings being held by another company. The result was that the company in which the employees were retained had no assets and accordingly there were no assets available to meet employee entitlements. The company with the majority of unsecured creditors also has no assets.
- We were able to maximise the return to creditors because the bank had a fixed and floating charge over all the assets. The existence of the charge allowed us to effectively "pool" so the purchaser of the business could acquire all the assets they required to run the business even though they were held in separate companies. If the appointment had been an administration it would have been much more difficult. Following our recommendation the assets and liabilities would have been grouped and there would have been sufficient assets available to have met the employee entitlements (an outcome consistent with the Commonwealth's position for protecting employees) and a small return to creditors rather than shareholders inequitably recovering the majority of the return.

## About The KordaMentha Research Unit

### Background

KordaMentha partners undertook the first voluntary administration in Australia, the largest voluntary administration in Australia (Ansett with 42 companies, 15,000 employees and >\$1 billion assets) and the largest group of voluntary administrations in Australia (Stockford with 84 companies).

The strength of the KordaMentha experiences and our expertise makes us well placed to monitor and evaluate issues and developments in the insolvency industry and to recommend changes.

### Statement of Direction

The KordaMentha Research Unit aims to:

- Develop intellectual property
- Share our knowledge of specialist topics with insolvency stakeholders
- Develop balanced solutions for issues in the industry. We will do this by preparing position papers on topics of interest, and encouraging discussion with a view that changes to the industry will result.

### Personnel

The KordaMentha Research Unit is headed by Andrew Malarkey ([amalarkey@kordamentha.com](mailto:amalarkey@kordamentha.com)). All KordaMentha Partners and Directors contribute to the KordaMentha Research Unit.

### Current Research

The KordaMentha Research Unit has conducted research in a number of areas, including:

- 301: Ansett - Part 5.3A and Chapter 11
- 302: Large and Complex Administrations – The Courts and Ansett
- 303: Regulatory Review of Australia's Insolvency Laws
- 304: Employee Entitlements
- 305: Rehabilitating Large and Complex Enterprises in Financial Difficulty

These papers can be accessed via the KordaMentha website – [www.kordamentha.com](http://www.kordamentha.com)