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case study

HOW TO TRADE ON PHARMACIES IN ADMINISTRATION

A case study to illustrate the practical and legal difficulties of trading on a pharmacy.

In the past it was almost unheard of for a pharmacy to go into administration or liquidation. However, increased competition, large franchise networks and continual reductions in the Federal Government's Pharmaceutical Benefits Scheme (PBS) rebates have all contributed to increased pressure on pharmacies in recent years.

As a result, more pharmacies are becoming insolvent. Insolvency practitioners and solicitors need to be aware of the complex regulatory environment and the practical challenges they will face in the external administration of a pharmacy.

The value of a pharmacy is almost entirely goodwill, as the assets are generally all financed and PBS approvals have significantly shrunk in value. If a pharmacy closes it runs the risk of losing its PBS approval. This means that to realise any goodwill an insolvency practitioner will have to try to trade on the pharmacy.

THE COUNTRY WELLNESS PHARMACY GROUP

This is a case study of the trading on and sale of a group of pharmacies: the Country Wellness Pharmacy Group (CWPG). It highlights the practical and legal difficulties of trading on a pharmacy, and identifies some of the unusual challenges facing the administrators and the approaches they took to overcome them.

In this instance the outcome was successful and resulted in the pharmacies being sold for around \$8 million. If they had been closed the return would have been minimal at best.

CWPG began as a single pharmacy in Darwin in 2012, gradually adding additional pharmacies in Darwin. In 2016 and 2017, CWPG expanded rapidly across the Northern Territory, Queensland, South Australia and Victoria on

the back of credit from various banks and financiers. It eventually became one of the largest suppliers to aged care and correctional facilities in Australia.

On 27 August 2018, Ian Currie and Stefan Dopking were appointed voluntary administrators of the CWPG, tasked with selling viable pharmacies as going concerns and closing others.

PHARMACY-SPECIFIC ISSUES

At the outset, the administrators had to notify federal and state government agencies, with the Department of Human Services assuming responsibility for the Medicare system. This notification allows for PBS rebates to be paid directly to the administration bank account.

Part of this notification process required the administrators to advise Medicare who they will retain to act as pharmacist-in-charge of each pharmacy (a legal requirement to operate a pharmacy). Thus, it's important to identify and gain the co-operation of key staff to preserve the pharmacy's value. Practitioners should be cautious of relying on locums, who are in short supply in many States and consequently, prohibitively expensive. The closure of non-profitable pharmacies also requires notification to regulators, which is dealt with below.

Traditionally, a PBS approval (technically an 'Approval to Supply Pharmaceutical Benefits') held significant value, even if the underlying pharmacy was closed or unprofitable. However, the current value of a PBS approval is minimal due to a combination of increased competition, restrictions on the ability to relocate approvals and the reduced profitability of pharmacies. In the view of specialist valuers, it holds no ascertainable commercial value for security lending purposes.

The value of a pharmacy is almost entirely goodwill, as the assets are generally all financed and PBS approvals have significantly shrunk in value.

Considering that often a pharmacy's plant and equipment is subject to finance, and fixtures and fittings are subject to both finance and make good requirements under leases, continuing to trade a pharmacy is the only realistic method of generating a material return to creditors.

Insolvency practitioners need to be mindful of operational issues surrounding the purchasing and dispensing of pharmaceuticals. The CWPG made daily deliveries to prisons and nursing homes, which the administrators had to monitor closely to ensure:

- There was adequate stock on hand to fulfil orders, having regard to funding restrictions.
- Proper procedures were in place and followed to ensure the correct medications were issued against prescriptions and wastage kept to a minimum.
- Customer statements were issued, paid and reconciled for over 1,000 patients.

Pharmaceutical stock can be difficult to track given drugs are generally ordered in boxes which are then opened, and the pills or patches sorted into individual packs for each patient at each facility. Counting and recording of stock on a per unit (e.g. per pill or patch) basis is not commercial. As a result, an opened box may not be fully consumed after all drug packing is completed for a delivery. Further, the inventory systems do not record stock as consumed until it is dispensed against a prescription.

Complicating the issue is that the pharmacy may be paid for one- or two-months' supply to a patient or nursing home but will deliver them over the period of time as the drugs are required by the patient. The administrators became reliant on the pharmacists and their assistants understanding the importance of minimising wastage and properly recording the use of stock.

PRACTICAL DIFFICULTIES IN TRADING ON

The personal liability for trading on expenses is the main impediment to deciding to trade on a business. In this case there were substantial costs in wages, expensive drugs and in a few cases very high rent (as much as \$40,000 per month on stores that had just started trading).

It was also clear that a number of the pharmacies were unprofitable and while they might be sold for a reasonable price, substantial losses would be accrued until a sale was completed. The sale of a pharmacy usually can be protracted due to the various regulatory approvals that are required.

As is typical for corporate groups, CWPG often transferred cash and stock between its various pharmacies. The older pharmacies generally supported the newer, which were established in shopping centres attracting higher rent and with little to no customer base. The administrators faced obvious challenges in continuing with such an arrangement.

The administrators were faced with the prospect of having to immediately close unprofitable pharmacies to protect themselves from personal liability given the various secured creditors were unwilling to indemnify them for their trading losses and costs.

Court applications

To solve this problem, the administrators sought urgent directions from the Federal Court permitting them to extend intercompany loans from profitable to unprofitable pharmacies. The direction sought was conditional on the administrators obtaining written approval from the primary secured creditor of the lending company before any intercompany loan was made.

They also sought to extend the grace period for a further three weeks before they became personally liable for any trade on expenses. This application was filed and heard within five business days of their appointment.

Intercompany loans

In making this application, the administrators' sworn evidence showed:

- The lack of external funding available.
- Difficulties the administrators had in obtaining accurate financials, engaging key staff, contacting key stakeholders (e.g. landlords) and being advised of secured creditors' intentions.
- The administrators' budgets and expected trading losses in comparison to the overall indebtedness of CWPG.
- The degree of mixing of assets, staff and operations within CWPG.
- CWPG's history of making intercompany loans.
- The extent of common secured and unsecured creditors across CWPG, and how those creditors might benefit from keeping more pharmacies trading until a sale or refinancing can be negotiated.

This evidence included commercially sensitive information which could have prejudiced the sale process. Therefore, the administrators obtained leave to have their affidavits kept confidential.

Trading on pharmacies

In granting the requested directions for the intercompany loans, Justice Derrington provided a useful summary of the relevant matters that justified such a direction including:¹

- CWPG's history evidenced a long-standing practice of profitable pharmacies underwriting losses of newer, unprofitable pharmacies. Therefore, the directions sought were consistent with CWPG's ordinary financial operations.
- The intercompany loans were for a limited purpose, being essential and ordinary business expenditure such as wages and stock purchases. His Honour considered such loans were appropriate by allowing the newer, struggling pharmacies to continue operating pending a sale or refinance.
- The loan period was for a very limited duration (three weeks), allowing the administrators to continue trading while expeditiously seeking a sale or refinance.
- Any potential losses from unprofitable businesses would be short-term and very small in proportion to the overall indebtedness of CWPG, meaning any prejudice suffered by creditors will be relatively insignificant.
- The administrators' commercial opinion was that the intercompany loans would allow the administrators to trade more pharmacies and likely result in a better return for secured and unsecured creditors.

An ancillary order excluded the administrators from personal liability for any intercompany loans if they could not be repaid from the assets of the lending company (otherwise such an order would have been futile if the administrators remained personally liable to repay them). The relevant principles for setting aside a voluntary administrator's personal liability are set out in *Re Mentha* (2010) 82 ACSR 142 at [30]:

- The arrangement is in the interests of creditors and consistent with the objectives of Pt 5.3A of the Corporations Act.
- The arrangements proposed are to enable continued trading for the benefit of creditors.
- The creditors of the company are not prejudiced or disadvantaged and stand to benefit from the administrators entering into the arrangement.
- Notice has been given to those affected.

The first three principles were satisfied in this case from the evidence put forward by the administrators.

The urgency of the application prevented the administrators in this case from giving notice of the

order sought to creditors. This was overcome by the administrators giving an undertaking to write to all creditors advising of the order and the ability to vary the order.

Extension of the grace period

To further facilitate the sale or refinance of the pharmacies, the administrators also sought orders extending the grace period before they became liable under s 443B of the Corporations Act in respect of equipment finance and property leases and franchise and licence fees.

The Court granted the extensions, based on the evidence that justified the intercompany loans as well as the complexities in determining ownership of certain financed assets and delays on the part of certain lessors responding to the administrators. As with the intercompany loan periods, the Federal Court was reluctant to grant too lengthy a grace period so the initial extension granted was for three weeks.

Further court applications

The complexity of this matter meant that the administrators had to make another application to extend the intercompany loan period and the grace period. Several applications were also required to extend the convening period (the possibility of which had been raised on the first application).

On each occasion the Court granted these applications. Primarily this was because the administrators were able to demonstrate ongoing progress in the administration and the sale of the pharmacies. Being on the Federal Court docket system, where the matter was assigned to one judge, certainly made this process of updating the Court and explaining why the further applications were required much simpler.

SALE OF PHARMACIES

Selling CWPG's pharmacies as going concerns represented the only realistic way of generating a material return to creditors. This presented challenges to the administrators by way of the limited pool of potential purchasers (licenced pharmacists), the provision of sensitive information to interested parties (who were also competitors) and privacy restrictions surrounding patient medical records.

To protect privacy, the administrators required interested parties to sign confidentiality deeds, before providing access to an online data room. The data room allowed the administrators to restrict the downloading and copying of information and monitor which parties were viewing which documents.

¹ Currie, in the matter of *The Country Wellness Pharmacy Group* [2018] FCA 1455. See also *Re Unlocked Ltd (Administrators Appointed)* [2018] VSC 345.

An additional benefit of carrying out this process was the administrators were able to advertise and organise the sale process themselves thereby saving substantial business brokerage commissions.

An additional challenge was the drafting of the sale agreement and the logistics of settlement. The licensing regime in the pharmaceutical industry requires both federal and state government approval of the purchaser, who must be a qualified pharmacist, thereby forming a condition precedent of the sale agreement.

This reduces the security generally provided by a deposit. If the regulators reject the purchaser's application for a pharmaceutical licence (like the purchaser being unable to demonstrate a right to occupy the premises or being unable to nominate a pharmacist-in-charge), the administrators would have had to return the deposit and bear their costs. This is a major change from the usual insolvency sale contract, but it wasn't practicable for the administrators to contract out this requirement as no pharmacy purchaser will agree to waive this precondition.

Obtaining each of these approvals also takes time and trying to rush them through to finalise a sale was very difficult (and not always successful).

Also, most potential pharmacy purchasers struggled with the usual clauses in an insolvency contract. While negotiations on such contracts are common these contractual negotiations took significantly longer than expected due to this issue.

In the sale of CWPG's pharmacies, the administrators had to cancel the respective pharmaceutical licence on the morning of the day of settlement. This was because Medicare requires the parties to confirm settlement is going ahead that morning and then cancels the old PBS number and activates the PBS number of the purchaser (which has been approved but not activated). There is no ability to transfer a PBS approval.

This process occurs before the money has been paid. This is a potential risk for the administrators, but it is also standard pharmacy practice. While the administrators can insist on funds in trust before settlement, that can't be done if a financier is involved. Careful diligence was required by the administrators to ensure there would be no last-minute issues at settlement.

Several other specific industry practices also had to be dealt with by the administrators including:

- Both annual and personal leave accrued by transferring employees had to be deducted from the sale price at a discounted rate.
- Numerous nursing home supply contracts had to be negotiated and completed with different parties.

- Ensuring that stock was either counted or dispensed at settlement thereby allowing the PBS monies to be paid to the administrators rather than the purchaser (with the nursing homes it was difficult to determine if stock had already been dispensed or supplied).

These examples show the importance of understanding industry practices when selling trading businesses, given prospective purchasers are already cautious due to the standard exclusions in insolvency practitioner contracts (otherwise the sale price will be too low due to a lack of interest from buyers in the particular industry).

As noted, PBS approvals hold nominal value. The process of realising that value is complicated. In the CWPG administration where pharmacies were not sold as going concerns and were closed, the administrators entered into an agreement to cancel the PBS approval of one pharmacy in order to allow another pharmacy to activate a new approval from the same premises. As this pharmacy was closed, a temporary deactivation had to be obtained from Medicare while the purchaser made arrangements to obtain regulatory approval.

To obtain a new approval the purchaser has to convince Medicare it can occupy the premises and dispense pharmaceuticals. There is limited time to complete this as Medicare will move to cancel the temporarily deactivated PBS approval completely. If that had occurred the company would have received no funds at all.

UNDERSTAND THE INDUSTRY

Overall, the CWPG administration highlights the challenges unique to external administrations in the pharmaceutical industry and the broad range of powers available to a court which can assist a voluntary administrator during a trade-on.

Practitioners need to properly understand the industry environment when taking on such a matter and should put evidence before the court that they have taken real, proactive steps to contact relevant stakeholders and that they have a clear plan which will satisfy the objectives of the voluntary administration regime. They should also be able to keep the courts informed throughout the sale process as the court will usually only grant short extensions while it assesses the progress being made by the administrators.

Done properly substantial returns can be made from this process. However, if missteps are made the practitioner can be left with no assets of any real value to realise. ▲