

## Chapter 1 - What Is Insolvency?

- There are two types of insolvency - Personal insolvency and Corporate insolvency
- There are two tests to determine solvency of an entity – “Cash-flow” and “Balance sheet”:
  - i. Under the Cash-Flow Test, a person (or company) is generally regarded as insolvent when he or she is unable to pay debts as they become due. This means that there are not sufficient resources available to pay creditors. In other words, can the person pay his or her way in carrying in his or her business?
  - ii. The Balance Sheet Test provides that the person or company is insolvent if total liabilities outweigh the value of the assets and therefore there are insufficient assets to discharge the liabilities. It is possible for a business to be “cash flow” insolvent and fail the cash-flow test but be asset sufficient and therefore able to satisfy the balance sheet test.
- Similarly, a business may be solvent on a cash-flow basis but its liabilities are greater than its assets.
- There are difficulties associated with both the abovementioned tests.
- Both the Bankruptcy and the Corporations Legislation however, appear to have adopted a cash-flow type test. Both section 122 of the Bankruptcy Act and section 95A of the Corporations Act adopt the cash-flow test.
  - i. Section 95A of the Corporations Act provides:

“A person is solvent if, and only if, the person is able to pay all of the person’s debts as and when they become due and payable.”
  - ii. Section 95A(2) provides:

“A person who is not solvent is insolvent”.
- There are also problems with what is meant with “being able to pay one’s debts as they become due”. Issues arise about the availability and access to funds to enable a person to pay debts.

- An example of the issue arises in the circumstance where a person is not solvent however he or she may be able to pay all debts if sufficient time is granted. In Noye; ex parte Deputy Federal Commission of Taxation it was held that a distinction must be made between a debtor who is able to pay his or her debts and a debtor who will be able to pay his or her debts at some future time. Only in the former situation can it be said that the debtor is solvent. Further in the High Court ( Sandell v Porter ) it has been held a debtor is not limited to his or her own cash resources in proving solvency. In determining solvency, the Courts will have regard to what the debtor can procure by realizing assets within a relatively short time. The debtor could sell assets or borrow money on the strength of his or her own assets in a short time and therefore be solvent. What is regarded as a short time will depend on the nature and amount of the debts and the circumstances of the debtor's business.
- Also a debtor is not necessarily solvent solely because he or she can raise a loan to pay debts. If a person can change the form of his or her property into cash by obtaining a loan, that suggests solvency. However, if the loan is not given as consideration for a mortgage or a pledge, the debtor is simply replacing one debt with another. In such a case the debtor's position suggests insolvency.
- Legislation both in the Bankruptcy Act and in the Corporations Act contains various provisions deeming insolvency in certain cases:
  - i. failing to comply with 459E notice in the Corporations Act;
  - ii. failing to comply with a Bankruptcy Notice under the Bankruptcy Legislation;
  - iii. section 40 of the Bankruptcy Act provides a number of acts regarded as acts of bankruptcy. They include, person conveying or transferring a property, creating a charge, making a payment or incurring an obligation that would if the person became bankrupt, be void against the trustee. Or, if a person with the intent to defeat or delay creditors, departs or remains out of Australia, or departs from his or her dwelling house or usual place of business or he or she otherwise absents himself or herself or he or she begins to keep house;
  - iv. It is also an act of bankruptcy for a person to sign an authority to call a meeting of that person's creditors;
  - v. failing to comply with various statutory provisions;

- vi. To establish the insolvency of an individual, a creditor who wishes to bankrupt the debtor must prove an act of bankruptcy on the part of the debtor within the six months preceding the presentation to the Court of a Creditor's Petition;
- vii. To establish the insolvency of a company, a creditor (or other person who is permitted to seek the liquidation of a company) will usually seek to rely on section 459C(2) of the Corporations Act. This sub-section allows a party seeking liquidation to rely on a statutory presumption of insolvency. A company is deemed to be insolvent if, during or after the three months ending, on the day when an application for winding up was made, it fails to comply with the terms of a section 459E notice of demand served pursuant to section 459F, execution of process issued against it on a judgment is returned wholly or partially unsatisfied, a receiver was appointed under a floating charge in respect of its property, an order was made for the purpose of enforcing a charge, a receiver entered into possession of its property in order to enforce a charge or a person was appointed to enter into possession to enforce a charge over its property;
- It also must be kept in mind that inability to pay debts must be distinguished from other reasons why debts have not been paid. The alleged debtor may refuse to pay, even though able to do so, because a bonafide dispute exists about whether there is a debt in fact owing, or as to the quantum of the debt. The debtor may have failed to pay through inadvertence or because of a desire not to pay. In these situations, the creditor must rely on the general processes of the law in order to recover his or her debt. The Courts which hear applications for the bankruptcy of an individual or the winding up of companies have emphasized that they do not exist to assist creditors to collect debts.

**Chapter 2 - Liquidation of a Company**

- If a company is insolvent, it may be wound up in essentially two ways.
  - i. Creditors can force its liquidation through a court order (compulsory liquidation).
  - ii. The alternative is members of the company will resolve to wind up their company.
- In circumstances where there is a compulsory winding up, this usually occurs by creditors initiating an application in a court and proving the company should be wound up in insolvency on a number of grounds. The most common of those grounds is failing to comply with a Statutory Demand.
- In a Voluntary Winding Up, however, there is no court involvement.
- No matter what form of insolvency occurs, a liquidator is appointed to administer the affairs of the company.
- Unlike in bankruptcy, the property of the company does not vest in the liquidator. The liquidator simply becomes the agent of the company. In a bankruptcy scenario however, the assets of the bankrupt actually vest or become the assets of the trustee in bankruptcy.
- Generally liquidators possess wide powers to enable the liquidator to investigate the affairs of the company and to discover the extent of the company's property. Once a liquidator has discovered and, if necessary, recovered the property of the company, the liquidator is required to realise the property and distribute the proceeds among the creditors, taking into account the rules established under the Corporations Act.
- The proceeds realised by the liquidator are distributed ratably or on a pro-rata basis amongst all creditors who succeed in proving that they are owed money by the company and that the debt is legally recoverable. Such debts are known as provable debts and the procedure involved in establishing the debt is known as "proving the debt". Creditors who have proved their debt are paid dividends from the realized property depending upon the total realizable assets and the total provable debts.
- Once the liquidator has completed the winding up and administration of the affairs of the company, it will be dissolved and this, in effect, represents the end of the company.

However, companies can be reinstated in certain circumstances. For instance, when a liquidator has not dealt with property discovered during the course of the administration.

- It is important to note that the two modes of winding up, voluntary winding up and compulsory winding up, are pursuant to the Corporations Act. Voluntary winding up takes two forms, a member's voluntary winding up or a creditor's voluntary winding up. Compulsory winding up is often referred to as a court winding up because an order of the court is required to commence the process.

### **Chapter 2a - Voluntary Winding Up of a Company**

- Voluntary winding up does not usually require a court process. In fact, a court will only be involved if a liquidator, a member or a creditor asks it to determine a question which arises in the liquidation (known as seeking directions), or to exercise any of the powers which the court has in a compulsory winding up.
- Voluntary liquidation is a statutory procedure governed under section 490 to 512 of the Corporations Act. It is a procedure which allows members to pass a special resolution to wind up the company whereby there will be a result in the distribution of assets amongst the creditors and, if there is any excess in assets, amongst the members. In such circumstances, as usual, the liquidator will be answerable to the creditors and members of the company.
- Section 490 provides an important limitation on companies winding up voluntarily. That section provides that if an application has been filed with the Court for the winding up of the company on the basis that it is insolvent, the company cannot resolve to wind up voluntarily unless the leave of the Court is obtained. This provision is designed to stop a company from frustrating the actions of creditors to wind up the company compulsorily. The directors of the company should be aware of such proceedings because the company would have to be served with the application to wind up. However, there will be a period of time between the filing of the application and its service when it is conceivable that the company will not be cognizant of the application. As a consequence it is wise for the company to search the registry of the Court.

- There are five situations which a voluntary winding up is taken to have commenced (see section 513B). The five situations are as follows:
  - i. if a winding up had begun when the resolution to wind up was passed, the commencement date of the initial winding up is taken as the commencement date for the second liquidation;
  - ii. if, immediately before the resolution was passed the company was subject to voluntary administration, the commencement day is the section 513C day, which means that if the company was in liquidation when the administration began, the day on which the winding up commenced or, if the company was not in liquidation, the day on which the administration commenced;
  - iii. If, immediately before the passing of the solution to wind up, a deed of company arrangement had been executed but not yet terminated, the commencement day would be the section 513C day which applied in relation to the prior voluntary administration;
  - iv. If the creditors had at a section 445F meeting resolved that a deed of company arrangement be terminated and that the company be wound up, the commencement day would be the section 513C day which applied in relation to the voluntary administration which ended when the deed was executed;
  - v. If none of the above applies, the commencement day would be date of the resolution to wind up.
- There are two forms of voluntary winding up. If the company is solvent, it is entitled to initiate a member's voluntary winding up. On the other hand, if the company is insolvent, the winding up must be a creditor's voluntary winding up.

### **Chapter 2b - Member's Voluntary Winding Up of a Company**

- This type of voluntary winding up is often undertaken as part of reconstruction of a group of companies or the termination of a company no longer in operation. As the company is solvent and the creditors will, it is expected, be paid in full, the liquidation does not need to involve the creditors, it is under the supervision of the members. Unless the company is an

exempt proprietary company or a subsidiary of a public company, the liquidator must be someone who is a registered liquidator with the ASIC.

### **Chapter 2c - Creditor's Voluntary Winding Up of a Company**

- The idea behind this type of winding up is that control of the liquidation should be in the hands of the persons who are directly affected by the liquidation i.e. the creditors. The Corporations Act permits creditors to appoint the liquidator (section 496(5) and section 499(1)), determine the remuneration of the liquidator, supervise the liquidator as he or she administers the affairs of the company and establish a committee of inspection to assist and oversee the liquidator.
- The members are excluded from being involved in the supervision of the winding up and this is indicative of the fact that creditor's voluntary liquidations are in many ways identical to compulsory liquidations.
- While the members are excluded from supervising the winding up, the administration can only be initiated by the resolution of the members. It must be emphasized that the supervisory role of the creditors in relation to the liquidation only comes in effect once the company has decided that it should be wound up. Although this form of winding up is called "Creditor's Voluntary" this does not mean that the creditors determine when the company is to be liquidated. That question is one to be made by the members. This does not mean that if the members do decide to wind up, then the creditors are deeply involved in the process of winding up. Most decisions will be made by a liquidator who is the person appointed to effect the winding up and he or she will do this according to the Corporations Act. The liquidator will, in many cases, take notice of the creditor's views or concerns but his or her primary function is to adhere to the provisions of the Corporations Act. The liquidator will act independently of the members and creditors.

**Chapter 2d - Compulsory Winding Up of a Company**

- This form of winding up is initiated by court order and is conducted under the supervision of the court. As a consequence, this mode of liquidation is more formal and costly as compared to voluntary liquidation.
- Compulsory winding up may occur when a person considers that a liquidation of a company is desirable, but the company does not want to be wound up. In such a case, there may be resort to the Court, which may appoint a liquidator. If the Court decides to order the winding up of a company, it will appoint an official liquidator to conduct the winding up. An official liquidator is an officer of the Court and is someone who has been registered as an official liquidator by ASIC. Usually, persons are only registered as official liquidators after obtaining considerable experience in insolvency work.
- The legislation enables the person making an application to the Court to nominate the liquidator to be appointed. The Court however has the overall power to appoint a liquidator it deems appropriate.
- Corporations Act provides that certain persons are at liberty to apply to the Court for a winding up order. These persons are set out in section 462(2) and include;
  - i. the company; or
  - ii. a creditor (including a contingent or prospective creditor of the company); or
  - iii. a contributory; or
  - iv. the liquidator of the company; or
  - v. ASIC; or
  - vi. APRA
- The most common applicants are creditors (such as the ATO).
- The Corporations Act also provides the grounds upon which an application may be made. These are set out in section 459A and section 461.

- Section 459A provides that an application may be made under 459P, enabling the Court to order that an insolvent company be wound up in insolvency. This is the most common ground upon which creditors rely to wind up a company.
- Section 461 lists a number of grounds including;
  - i. the company has by special resolution resolved that it be wound up;
  - ii. the company does not commence business within one year from its incorporation or suspends its business for a whole year;
  - iii. the company has no members;
  - iv. the directors have acted in affairs of the company in their own interests rather than in the interests of the members as a whole, or in a manner that appears to be unfair or unjust to other members;
  - v. the affairs of the company are being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members or in a manner that is contrary to the interests of the members as a whole;
  - vi. an act or omission or a proposed act or omission by or behalf of the company, or a resolution or proposed resolution, by a class of members of the company, was or would be oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or
  - vii. ASIC has stated in a report prepared by it that in its opinion it is in the interest of the public that it be wound up; or
  - viii. If an application is made by APRA that it is in the interests of the public that it be wound up;
  - ix. The Court is of the opinion that it is just and equitable that the company be wound up.
- In some cases it is difficult to establish insolvency, so the Corporations Act has provided there are six situations which a company will be presumed to be insolvent. Of these, it is probably appropriate to say that the presumption most commonly relied on by creditors is that the company has failed to comply with a claim which has been made in a statutory demand served pursuant to section 459E.

- A Court may also order the winding up of a company in insolvency if it is found, in an application for the liquidation of the company that the company is insolvent.
- It is important to note that the Court has been given the absolute discretion as to whether it will grant an application to wind up a company. That is, even though insolvency may exist the Court can still decide not to wind up a company.
- The actual procedures involved in each of the windings up referred to above are detailed and have statutory provisions which provide for how each occurs and is initiated. Those matters may be dealt with in a further paper and discussion.

**Chapter 3 - Voluntary Administration of a Company**

- Voluntary administration provides for the appointment of an insolvency practitioner, who is known as an administrator (usually a liquidator), to take control of a corporation's affairs during a period of moratorium and investigation with a view to developing what is called a "Deed of Company Arrangement". The arrangement would regulate the relationship between the corporation and its creditors.
- The aim of voluntary administration is to investigate the possibility of keeping companies alive rather than terminating them under a liquidation scenario.
- An administration of a company is initiated by the appointment of an administrator by one of the following;
  - i. the company;
  - ii. a liquidator or provisional liquidator of the company;
  - iii. a chargee (mortgage) of the whole, or substantially the whole of the company's property where liquidation is not occurring.
- Usually the company appoints the administrator by document under seal. A decision is made by the board of directors who have resolved that the company is insolvent or is likely to become insolvent at a future date and an administrator should be appointed to it.
- Usually directors may be advised to place a company into administration to avoid the possibility of them incurring liability for insolvent trading under section 588G of the Corporations Act.
- On appointment, the administrator is obliged to lodge a notice of his appointment with the ASIC before the end of the next business day after the date of the appointment.
- The administrator must either publish a Notice of Appointment in a national newspaper or daily newspaper which circulates in the jurisdiction in which the company has its registered office or carries on business.
- The company must be notified of the administration before the end of the next business day if the administrator is being appointed by a charge holder.

- There are certain requirements which provide for the commencement of the appointment. First, the administrator cannot be appointed if the company is already subject to a voluntary administration. Second, if the company is being wound up, the company cannot resolve to appoint an administrator. Third, the company or a liquidator is only able to appoint an administrator if it is thought that the company is insolvent or is likely to become insolvent at some future date. Fourth, a secured creditor holding a charge over the whole, or substantially the whole of the company's property is only entitled to appoint an administrator if his or her charge become, and still is, at the time of the appointment, enforceable.
- The administration will continue until it is terminated by one of the following events:
  - i. A Deed of Company Arrangement is executed by the company and the deed's administrator;
  - ii. The company's creditors resolve that the administration should end;
  - iii. The company's creditors resolve that company should be wound up;
  - iv. The Court orders the end of the administration;
  - v. The period prescribed by section 459A(5) for the meeting of creditors ends without the convening of the meeting;
  - vi. The creditor's meeting convened under 459A ends without a resolution of under 459C being past;
  - vii. The company fails to execute a proposed Deed of Company Arrangement;
  - viii. The Court appoints a provisional liquidator or orders winding up.
- There is also the power which the Court has to terminate an administration if the Court is of the view that the company is solvent or the provisions of the administration sections are being used for an improper purpose.
- Once an administrator is appointed, the administrator takes control of the business and property of the company and begins investigating its affairs. After giving the requisite time to interested parties of his or her appointment and within eight business days of his or her appointment, the administrator is obliged to convene and hold a meeting with creditors at

which the creditors may remove the administrator and replace him or her and decide whether to appoint a committee of creditors.

- The right to replace the administrator enables creditors to take action where the directors of the company have appointed someone who may be sympathetic to them and their management.
- After the first meeting, the administrator must continue his or her investigation in order to decide whether the interests of the creditors would best be served by proposing an arrangement, terminating the administration or winding up of the company.
- A second meeting must be convened and held. The second meeting must be held within five business days after the close of the convening period. The convening period is set out in section 439A(5). If the administration begins on a day in December or is less than 28 days before Good Friday, the period is 28 days from the beginning of the administration. Ordinarily the period will be 21 days from the beginning of the administration. This period can be extended by the Court or can be extended by resolution to adjourn the meeting. Meetings can be adjourned up to 60 days.
- In convening the second meeting, the administrator must send to the creditors a notice, a report of the company's affairs and a statement explaining the administrator's opinion about what should happen to the company and if an arrangement is proposed, the details of that arrangement (section 439A(3)(4)).
- At the second meeting the creditors can decide on whether the company should execute a Deed of Company Arrangement, the administration ends or thirdly the company be wound up.
- If creditors opt for a Deed of Company Arrangement, the administrator is appointed the administrator of that deed. The administrator must prepare an instrument defining the terms of the deed. This is usually prepared by lawyers on behalf of the administrator although some administrators prepare their own deed.
- If the creditors resolve at the second meeting that the company should be wound up, the administrator becomes the liquidator of the company which is deemed to be wound up. This is essentially a voluntary liquidation by creditors appointment.

**Chapter 3a - Effect of Administration of a Company**

- The administrator takes control of the company's business, property and affairs. During the period of voluntary administration, the company's property can only be dealt with by the administrator, or with his or her written consent, or by leave of the Court. Transactions not so sanctioned are void. Any transfer of shares or alteration in the status of the members is void except where the Court otherwise orders.
- The position and property of the company will be protected after the appointment because there is a statutory moratorium as far as pre-appointment liabilities are concerned.
- The appointment means that officers of the company lose the right to use their power. They can only exercise powers with the written approval of the administrator.
- Officers of the company are not removed from their positions and may take over their powers if and when the administration ends. The term 'officers' includes receivers, court-appointed receivers, court-appointed liquidators and provisional liquidators. Employees are not encompassed by the expression. Employees are not specifically affected by the legislation except to the extent of their entitlements.
- Contracts with the company are not automatically terminated. An administrator does not appear to have any statutory right to disclaim contracts. If an administrator chooses to repudiate a contract, the other party will, as is usually the case, under a receivership, be left with an unsecured claim against the company for damages.
- The appointment of the administrator leads to a statutory moratorium which substantially affects the creditors. As a consequence of the moratorium, amongst other things, legal proceedings, winding up proceedings and execution against company property cannot be commenced or prosecuted. Creditors who claim title to assets (for example under lease agreement, supply of goods on consignment, retention of title clauses) may be able to preserve their position by repossessing their assets. In administration, those creditors will face significant restrictions to exercising their rights.
- Unsecured creditors will be entitled to vote at the two creditors meetings. They may vote to remove the administrator and appoint someone else, to vote to determine if there should be

a committee of creditors appointed, and decide amongst other things whether or not to accept the Deed of Company Arrangements.

- Creditors who have supplied goods pursuant to a contract that includes a retention of title clause are unable to recover them unless the subject matter of the contract is perishable property. Those creditors however can do so if the written consent or leave from the Court.
- Creditors who have rights to assets that have been leased to the company are in the same position as creditors possessing rights pursuant to a retention of title clause, are unable to repossess the assets during the period of administration. This does not apply to lessors who hold a charge over the whole, or substantially the whole of the property of the company.
- If an administrator continues to use or possess leased assets for more than 7 days after commencement of the administration, the administrator is personally liable for so much of the rent or other amount owing in relation to the period following the 7 day period after the administration commences. If leased property is retained by the administrator, the administrator is not taken to have adopted the whole contract relating to the leased assets. The administrator is entitled to dispose of leased property only in the course of business or with the written consent of the lessor or owner or with the leave of the Court. The Court is only to grant leave if it is satisfied that arrangements have been made to protect adequately the interest of the lessor or owner.
- If an administrator makes a payment or enters into a transaction or does any act or thing in good faith, or an act is done with the consent of an administrator, it is valid and effectual for the purposes of the Corporations Act and it cannot be set aside in subsequent winding up of the company. Consequently any payments made by the administrator cannot be impugned as unfair preferences if the company was to go into liquidation at a later stage. A transaction or dealing entered into by or on behalf of the company is void unless it is effected by the administrator, the administrator consented to it in writing before being effected or it was effected pursuant to a court order. If an officer of the company is knowingly concerned in or party to a void transaction, he or she is in breach and commits an offence which can be punished by fine or imprisonment. Further, officers can be ordered to pay compensation to the company or other persons. Certain transactions which are prima face void are, as they would be in a liquidation under section 468 exempt. These transactions involve payments by an Australian bank out of an account kept by the company with the bank where the payment

is made in good faith and in ordinary course of the bank's banking business. These payments, to be exempt, must be made on or before the day on which the administrator gave to the bank written notice that the appointment had begun or before the administrator published notice of the appointment, whichever occurs first.

- During the administration the position of shareholders is frozen and they cannot deal with their shares.

### **Chapter 3c - Creditors Meetings (Voluntary Administration)**

- As indicated above there are two meetings of creditors of importance in a voluntary administration. The first meeting and the second meeting. The first meeting is to occur within 8 business days of the commencement of the administration. The purpose of that meeting is to allow the creditors to determine whether to appoint a committee of creditors and also whether to remove the voluntary administrator. The functions of a committee (similar to that of a committee of inspection in liquidation) are to consult with the administrator about matters relating to the administration and to receive and consider reports prepared by the administrator. Unlike a committee of inspection, the committee cannot give directions to the administrator but it can compel an administrator to report on issues relating to the administration. The membership of the committee is explained by the legislation. Primarily members can be constituted by creditors of the company, the attorneys of creditors or persons authorised in writing by creditors to be members.
- First meeting must be convened by the administrator giving written notice of the meeting to as many creditors of the company as reasonably practicable and advertising the meeting in the national newspaper or in a daily newspaper that circulates generally in each jurisdiction in which the company has its registered office or carries on business. These things must be done at least 2 business days before the meeting.
- The second meeting of creditors is far more substantive than the first. The convening of the second meeting can be extended provided it is extended within the convening period.
- At the first and second meetings the administrator is to preside.

- The meeting may be adjourned from time to time but can only be adjourned for up to 60 days from the date when the meeting was first held. The provision for the adjournments permits time in which negotiations can occur in relation to any proposals put to the meeting.
- If no resolution on the future of the company is made within 60 days, the administration automatically comes to an end and the directors will again resume control.
- At the second meeting creditors may resolve to accept one or the following;
  - i. That the company execute Deed of Company Arrangement;
  - ii. That the administration should end;
  - iii. That the company be wound up in insolvency.
- The second alternative above would see the end of the moratorium and a return of the management of the company to the directors. If the last alternative occurs, the company would immediately commence to be wound up and the administrator automatically becomes the provisional liquidator and then the liquidator of the company unless the Court declares the company to be solvent within 7 days of the resolution.
- As far as voting is concerned, the formula used is the same as that used for liquidations. So essentially voting at such meetings occurs on the same basis at voluntary administration meetings as it does for liquidation meetings. The regulations provide that the regulations applicable to liquidations also apply to the voluntary administration scenario. That is, regulations 5.6.12 to 5.6.36A.
- A resolution can be carried on the voices (or a show of hands). If a poll is demanded, the resolution is past if a majority of the creditor's voting (whether in person, by attorney or proxy) vote in favour of the resolution and the value of debts owed to those voting in favour of the resolution is more than half the total debts owed to all creditors voting. If no result is reached, the administrator (who will usually be the person presiding at the meeting) may exercise a casting vote. The administrator is not required to exercise such a vote.
- Sections 600A to 600E supplement the voting formula. Section 600A provides, amongst other things, that if a resolution has been voted on and if the votes of a related creditor(s) of a company was disregarded, either the resolution which was passed would not have been passed or the resolution which was not passed would have been passed or the issue would have been decided on the casting vote, the result is contrary to the interest of creditors as a whole or is

reasonably likely to prejudice creditors, the Court is empowered to order, amongst others, that the related creditor(s) not be entitled to vote. This implements the recommendation of the Harmer Report that unfair influences of related person creditor over creditors meetings be prevented.

- Section 600B applies where a resolution is passed by the casting vote of a chairman. A creditor who voted against the resolution may apply to the Court for an order setting aside or varying the resolution. Similarly, under section 600C if a resolution is not passed because of the casting vote of the chairperson or the chairperson refuses or fails to exercise a casting vote, creditors who voted for the resolution can apply to the Court for an order that the resolution is taken to have been passed.
- It should be noted that regulation 5.6.24 which requires secured creditors to surrender their security if they wish to vote or permits them to vote only in respect of the balance owing if they retain their security is not applied to meetings under the administration provisions. This is so secured creditors will continue to be involved in the voluntary administration process. Creditors however in general are not entitled to vote unless their debts have been admitted wholly or in part by the administrator or they have lodged with the chairperson particulars of their debts, or if required, a formal proof of debt. Creditors are not entitled to vote in respect on unliquidated debts, contingent debts, unliquidated or contingent claims or debts the value of which have not been established unless a just estimate of the debt's value has been made.
- The chairperson has the power to admit or reject a proof of debt for the purposes of voting. If the chairperson has doubts about a proof he or she must mark the proof as objected to and allow the creditor to vote, subject to the vote being declared invalid if the objection is sustained. The decision of a chairperson in relation to a proof can be subject of an appeal to the Court. The appeal must be lodged within 14 days.

### **Chapter 3d - Deed of Company Arrangement**

- The idea of the Corporations Act in respect of Deeds of Company Arrangement is for flexibility. Therefore the contents of any deed are to be allowed to meet circumstances of the company and its creditors. The arrangement may involve a simple moratorium or a set period which allows for

the freezing of claims, a composition of creditor's claims whereby creditors agree to accept less than what is owed, or a plan to pay creditors in instalments or a mixture of the foregoing.

- An administrator of a deed must be appointed. This does not have to be but usually is, the administrator of the administration because he or she is conversant with the affairs of the company. If the creditors refrain from passing a resolution to appoint someone else to be administrator of the deed, the administrator will become the administrator of the deed. It is up to the administrator to provide the creditors with the terms of the deed. Certain matters must be included in the deed. These are set out in section 444A (4). They include:
  - i. Who will be the administrator;
  - ii. The property of the company available to pay creditor's claim;
  - iii. The nature and duration of any moratorium period;
  - iv. The extent to which the company is to be released from debts;
  - v. The circumstances which will see the deed terminate;
  - vi. The day on or before which the claims must have arisen if they are admissible under the deed;
  - vii. The order in which the proceeds of property of the company are to be distributed amongst creditors.
- Certain provisions will apply to a deed unless specifically excluded under the legislation. These provisions are specified in the regulations.
- If creditors resolve that a deed of arrangement is to be entered into, then the deed must be executed by the company within 21 days of the meeting or such time as the Court allows. The administrator is also required to execute the deed and this is to be done as soon as practicable after the company has executed it. If the company fails to execute the deed the administrator becomes the provisional liquidator of the company. If the deed is not executed the administrator is obliged to file with the ASIC a notice to this effect and publish notices as prescribed.
- Once a deed is executed by both the company and the administrator, it becomes a Deed of Company Arrangement. It is incumbent on the administrator to send to each creditor of the company written notice of the execution of the deed and to cause a notice to be published in the

national newspaper or in a newspaper which circulates generally in each jurisdiction in which the company has its registered office or carries on business.

- Once the deed is executed the administration terminates, the moratorium restrictions come to an end and are replaced by the deed provisions and any statutory provisions that apply.
- The administrator of the deed is, in carrying out the duties arising under the deed, acting as agent of the company. In administering the deed the administrator is empowered by the regulations. These regulations grant the administrator a number of powers.
- If a deed is approved by the creditors, they are bound by its terms even prior to its execution and must not do anything inconsistent with the deed except with the court's approval. The deed binds all creditors so far as any claims arise on or before the time specified in the deed. Usually this is the date of the appointment of the administrator. The consequence is that until the deed comes to an end, no creditor bound by the deed is permitted to apply for the winding up of the company or proceed with an application to file before the deed becomes binding. A creditor would not be able to initiate or prosecute proceedings or enforce process without leave of the Court.
- Secured creditors are able to deal with their security and therefore are not bound by the deed unless they voted in favour of the deed or they are prevented by the court order from doing otherwise. In order to stop a secured creditor from threatening the validity of the entire deed the Court has the power to order that a creditor not realise or deal with its security if satisfied that such an exercise would have a material adverse effect on achieving the purposes of the deed and the creditor's interest will be adequately protected under the deed. The same situation applies in respect of owners and lessors of the property which is in possession of the company. The Court will only order an owner or lessor not to take possession of its property if it is satisfied that for the owner or lessor to take possession of the property would have a material adverse effect on achieving the purposes of the deed, and having regarded the terms of the deed, the terms of the order and any relevant matter, the interest of the owner or lessor would be adequately protected.
- The deed will bind the deed administrator of the company and its officers and members. It will, also, release the company from a debt to the extent that the deed provides for the release of the company and to the extent that the creditor is bound by the deed. While the company is operating under a deed, every public document and every eligible negotiable instrument of the

company must have the word “Subject to Deed of Company Arrangement” after the company’s name.

- The administrator may find that he or she is personally liable when a company is administered under a Deed of Company Arrangement for relevant tax instalment deductions due, but unremitted to the Commissioner of Taxation, in relation to the earlier administration of the company. The administrator’s right to be indemnified from the company property extends to that liability but not beyond the period of administration. Therefore if not all instalments (such as group tax deductions) are remitted before the end of the administration, he or she would be liable for them unless he or she ensures that there is a satisfactory indemnity from the company or a creditor(s) in place when the Deed of Company Arrangement becomes operative.
- It is possible for a deed to be drawn up so as to prefer some unsecured creditors over other creditors. This is provided that the overall arrangement is in the interest of creditors generally. However, Court decisions have made it clear that the priorities cannot displace the provisions of the Corporations Law particularly in section 556. Entitlements in priority under that section must be adhered to. If there are to be any preferred creditors, they will be within the priority categories rather than between them. For example, a group of unsecured creditors would be preferred over other unsecured creditors in terms of quantum provided they are within the same category of priority in section 556.
- Deeds of Company Arrangements may be varied. They may also be terminated or avoided. A meeting of creditors may be convened for the purposes of variation of a deed or termination of a deed. A meeting may be convened for this purpose by creditors of not less than 10% of the value of all claims.
- Any meeting must be in writing and advertised. A notice must be sent to creditors setting out the proposed variation to the deed and that any meeting of creditors a resolution may agree to do so.
- A Deed of Company Arrangement will terminate if;
  - i. The court so orders;
  - ii. The creditors so determine by resolution;
  - iii. The circumstances in the deed providing for termination have been fulfilled.

- Section 445D sets out the 7 grounds upon which a deed may be terminated. They are:
  - i. Information about the company's affairs was given to the administrator or creditors and was false or misleading;
  - ii. False or misleading information was contained in the statement provided to creditors for the convening of a meeting;
  - iii. There was an omission from the statement of the company's affairs and it would have been material to the creditors in their decision;
  - iv. There was a material contravention of the deed by someone bound by it;
  - v. The deed cannot be given effect without injustice or undue delay;
  - vi. The deed or a provision of it would be oppressive or unfairly prejudicial or unfairly discriminatory against one or more creditors or contrary to the interest of the creditors of the company as a whole;
  - vii. The deed should be terminated for some other good reason.
- An application to terminate a deed may be made by a creditor of the company or an interested person.
- A deed may also be terminated by a resolution passed at a meeting of creditors. Creditors may convene such a meeting if they have not less than 10% in value of the all the creditor's claims against the company.
- In the event of the termination or avoidance of the deed, wholly or partly, the previous operation of the deed is not affected. Consequently what occurs before the termination or avoidance is not, unless it was itself a breach of the Corporations Act, rendered void.

## **Chapter 4 - What is Bankruptcy?**

- Bankruptcy is an extensive area of the law and may be dealt with as a separate subject. What follows is an outline of the important provisions of the Bankruptcy Act.
- Bankruptcy is a legal process that controls the affairs of people who are insolvent.
- Bankruptcy Act also provides an alternative to bankruptcy under Part X of the Act. There are also informal arrangements with creditors for small debts under Part IX.
- A bankruptcy can occur in 2 ways.
  - i. The person can present his or her own petition, a debtor's petition. The petition is presented to ITSA. If the petition is accepted, the person is made bankrupt.
  - ii. A creditor may apply to the Court for a Sequestration Order against the estate of a debtor.
- Bankruptcy applies to any debtor other than a corporation, partnership, association or company registered under a law which provides for the winding up of the partnership or association.
- The process for a debtor's petition is straightforward. The debtor lodges a statement of affairs with ITSA and if the registrar accepts that the person is insolvent, a bankruptcy results.
- If a creditor wishes to initiate bankruptcy proceedings against the debtor, he or she must be able to establish an act of bankruptcy has been committed and present a Creditor's Petition to the Court within 6 months of that act of bankruptcy. The Court has a discretion whether to make a Sequestration Order in all cases.
- Once a person is made a bankrupt, a trustee is appointed and most of that person's property will vest in the trustee.
- The trustee can be the official trustee or a private trustee.
- The only assets which do not vest are those specifically excluded by section 116 of the Bankruptcy Act.

- The trustee will then have the task of ascertaining the liabilities and assets of the bankrupt. The trustee has examination power and powers to investigate. Bankrupts are required to assist a trustee in such investigations.
- Once the trustee has discovered and, if necessary, recovered the bankrupt's property, the trustee is required to realise the property and divide the proceeds amongst the creditors in accordance with the rules established under the Bankruptcy Act.
- The proceeds of the realised estate are distributed ratably amongst all creditors who succeed in proving that they are owed money by the bankrupt and that the amount owed is legally recoverable as a bankruptcy debt. Such debts are known as provable debts and the procedure involved in establishing the debt is called "proving the debt". Creditors who have proved their debt are paid dividends by the trustee.
- A bankrupt will be able to get an automatic discharge from bankruptcy 3 years from the date on which he or she has filed a statement of affairs, unless an objection is made to the discharge. A bankrupt may seek an early discharge at any point 6 months after the filing of his or her statement of affairs. To obtain an early discharge the bankrupt must apply to his or her trustee.
- The effect of discharge is to release the debtor from all debts which were provable in his or her bankruptcy, so that if there is any balance of indebtedness remaining the creditors are not able to enforce any rights against those claims.
- There are important procedures which assist creditors in respect of bankruptcy. For instance, creditors who are pursuing the payment of a debt from a debtor might be concerned that the debtor might abscond or dispose of his or her assets before any bankruptcy order can be made. The Bankruptcy Act provides procedures which, although not usually used, can be useful in such circumstances. A creditor, for instance, may apply to the Court for the issue of a warrant for the arrest of the debtor and for an order providing for the seizure of property of the debtor where a Bankruptcy Notice has been issued, a petition has been presented against the debtor, the debtor has absconded or is about to abscond, with a view to avoiding payment of his or her debts or to prevent or delay proceedings under the Act. Similar orders can be made where there is evidence that the debtor has concealed or removed, or is about to conceal or remove any of his or her property. It is also possible for an interim order from the Court for Sequestration of the debtor's estate. The court may appoint an interim receiver of the debtor's estate after a Creditor's Petition has been presented and before sequestration. Usually such orders are not often made

but they can be made where there is evidence that there is a likelihood a debtor will dispose off or put assets beyond reach of creditors. The receiver appointed in such cases is usually either the official trustee or a private trustee. There is a risk however in these situations because if this petition were to be dismissed, the debtor may have a claim for damages resulting from the appointment of the receiver and control of the debtor's property. Therefore such appointments are usually made in rare circumstances.

#### **Chapter 4a - Bankruptcy and Recovery of Property**

- A trustee can claim all property belonging to the bankrupt at the commencement of the bankruptcy and all property acquired by the bankrupt between the commencement of the bankruptcy and the date of bankruptcy.
- There is also a doctrine known as "relation back" arising from sections 115 and 116(1) of the Bankruptcy Act. This entitles the trustee to property, which would not otherwise be available to him or her at the date of bankruptcy. The rationale of the doctrine is that the trustee should be permitted to have vested in the trustee all property of the bankrupt from the time of the commencement of the bankruptcy. It should be noted here that the commencement of the bankruptcy may be an earlier date to the actual sequestration. It should also be noted that there will be no relation back period where a debtor's petition has been presented and the debtor did not commit an act of bankruptcy in the 6 months proceeding the presentation of the petition. Therefore, quite often there is a limitation on the trustee's entitlements in circumstances of a debtor's petition.
- The doctrine of relation back can be illustrated by the case of the Trevor Newton Small Superannuation Fund. In that case, the bankrupt had placed monies into his superannuation fund within the relation back period, that is after the commencement of bankruptcy. Those monies were recoverable by the trustee as being an asset of the trustee notionally even before the Sequestration Order being made by the Court.

## Chapter 5 - What are Preferential Payments?

- Preferences are applicable both in circumstances of bankruptcy and corporate winding up. This is an extensive area of the law and will only be dealt with in brief terms here.
- In the bankruptcy context, preferences are dealt with under section 122 of the Bankruptcy Act.
- Payments or transfers which are made shortly before the commencement of bankruptcy will be subject to recovery by trustees.
- If a payment or other transaction is deemed to be a preference, the creditor preferred must pay back the amount received to the trustee. The amount paid back or property returned to the trustee will then be available for payment to creditors. A creditor who is deemed to have given a preference is permitted to claim in the bankruptcy after repaying the preference to the trustee.
- To have a transaction set aside as a preference the trustee is required to establish 5 things;
  - i. The transaction in question is within one of the classes of transactions mentioned in section 122(1). For example, it was a payment or a transfer of property;
  - ii. At the time of the transaction the bankrupt was insolvent;
  - iii. The person favoured by the transaction was a creditor of a bankrupt;
  - iv. The effect of a transaction was to give the creditor who was a party to the transaction a preference over other creditors; and
  - v. The transaction occurred within one of the periods specified in section 122.
- All elements must be proved by a trustee who seeks to allege an undue preference. Even if the trustee can prove all five elements, a creditor whom the trustee alleges has received the preference, is not without defence. Section 122(2)(a) contains defence provisions for the creditor. The creditor will not have to disgorge an alleged preference if the creditor can prove that the creditor took the benefit of the transaction in circumstances where;
  - i. The creditor acted in good faith;
  - ii. Paid or provided market value for the transaction; and
  - iii. Acted in the ordinary course of business.

- There are many cases dealing with preferential payments. What is important to remember is that the trustee must prove all of the elements before he or she can make a claim or recovery of what generally is a payment of money as a preference. That is not the end of the matter because the creditor quite often has a reasonable and legitimate defence to the claim.
- Looking at the 3 elements of the defence;
  - i. Good faith – often this is the most difficult element to establish because of the indefinite nature of the phrase “good faith”. This indicates honesty and propriety in the sense that there is absent, on the part of the creditor, any knowledge that a preference has been given. The creditor bears the burden of proving, on a subjective basis that he or she has acted in good faith. It is often said in the cases that for a creditor acting in good faith, that creditor must have believed in his or her own mind that there was no need to question the payment or transfer. The creditor honestly accepted the payment was made with all propriety. However, even if the creditor can prove good faith, subjectively, the creditor may fail against the trustee. This is because of section 122 (4)(c) that provides that good faith is negated if the circumstances are such as to lead to the inference that the creditor knew, or had reason to suspect, that the debtor was unable to pay his debts as they became due from his or her own money and that the effect of the transaction would be to give the creditor a preference, priority or advantage over other creditors. This section focuses on circumstances and not the state of mind of the creditor or the debtor. As a result, it provides for an objective test. It also means, with the inclusion of the words “reason to suspect”, that a creditor can fail if he or she is regarded as having constructive knowledge of the debtor’s insolvency and that the payment was preferential. The objective test takes precedence over the subjective test and the result that no matter what the creditor thought, if the circumstances create an inference that there was reason to suspect, according to the standards of an ordinary reasonable man, that the debtor was insolvent and that the payment would constitute a preference, the creditor will fail.
  - ii. Market value is a new term which has been incorporated into section 122. Such will depend upon the circumstances of each case. Whether adequate value has been supplied will depend upon the nature of the transaction and the factual matrix. It is up to the creditor to prove that market value has been provided.

- iii. In the ordinary course of business – in the Corporations Act this aspect has been abolished because it is difficult. It is not necessary to consider the ordinary business practice in the trades or fields in which the debtor and creditor are involved, or what is usual in the business of the creditor or debtor. An example of payment not in the ordinary course of business is a payment received by the creditor after obtaining a judgment against the debtor and issuing a writ of execution. A payment received after the issue of Bankruptcy Notice will make the same result. While the mere issuing of legal proceedings may not, in some circumstances, mean that the subsequent payment of the initiator of the proceedings was otherwise than the ordinary course of business such action often militates against the payment being in the ordinary course of business. Besides investigating the transactional relationship between debtor and creditor, one must also consider the intentions of the parties. In one case the debtors mind was relevant and the debtor made payment to a creditor with the intention of preferring the creditor, that precludes the conclusion that it was in the ordinary course of business.

### **Chapter 5a - Preferences under Corporations Act**

- Unfair preferences are dealt with in section 588FA of the Corporations Act. A transaction is an unfair preference if the company and the creditor are parties to the transaction and the transaction results in the creditor receiving from the company, in relation to an unsecured debt owed to the creditor, a greater amount than it would have received in relation to the debt in the winding up of the company. This applies even if the transaction is entered into before the court order winding up the company.
- First, a liquidator will have to prove that the alleged preference is a “transaction” within the definition of that term. The term is defined in section 9 of the Corporations Act very broadly. The definition sets out a number of examples and does not purport to be exhaustive, notably it encompasses more types of transaction than those mentioned in section 122 of the Bankruptcy Act.

- Secondly, section 588FE provides that the transaction, that is alleged to be a preference, can only be set aside if it is capable of being categorized as an insolvent transaction, pursuant to section 588FC and thirdly, the transaction occurred within a specified time zone. The effect as with an undue preference it will be encumbered upon the liquidator to establish that the company was insolvent at the time of giving the alleged preference and that (usually) this occurred within the 6 months proceeding the relation back day or between that date or that day and the commencement of the winding up.
- Thirdly, it must be proved that the creditor received more than he or she would have in winding up. That is, an advantage or preference was received.
- The time the preference allegedly occurred is critical. For many years, 6 months before the relation back day has been regarded as the crucial period and the only time in which the transaction could be set aside as a preference. However, if a creditor who was a party to the transaction was a related entity of the company, the time zone in which the preference must have occurred is a 4 year period before the relation back day under the Act.
- In relation to section 122 of the Bankruptcy Act the most difficult of the conditions which a liquidator had to establish (when it was used in the Corporations Law) was the insolvency of the debtor company at the time giving the alleged preference. The liquidator is still required to prove this under the new regime. The determination of whether a company is solvent cannot be based solely upon an investigation of a balance sheet. However, there is authority for the proposition that a reconstructed balance sheet could be admitted into evidence and taken into account.
- The meeting of insolvency, is determined by the Courts, was discussed earlier in this paper. As mentioned above, "insolvency" has now been defined in Section 95A of the Corporations Act as meaning, in effect, being unable to pay debts as they become due and payable. The definition is very brief and the principles developed in cases are quite complex.
- If a transaction is held to constitute a preference the recipient is required to pay back the benefits received in favour of the liquidator who will use the money or property recovered to pay and distribute amongst the general body of creditors. A creditor who receives a preference and who is required to pay back such preference can prove in the liquidation in respect of the amount which is owed by the company to him or her.

**Chapter 5b - Voidable Payments**

- This is an extensive area and involves both Bankruptcy and Corporations.
- In Bankruptcy, it involves the provision of Section 122 as indicated above, sections 120, 121 and section 123. It also involves the relation back doctrine as we have mentioned earlier. These provisions should be dealt with separately in a separate paper as they are extensive.
- With respect to Corporations, uncommercial transactions are now dealt with within Part 5 of the Corporations Act.
- In Corporations Act there are what is known as “insolvent transactions” under section 588FC, and if, in addition, they were entered into during the two years prior to the relation back day or within the relation back day they are voidable transactions under Section 588FB. Section 588FB articulates uncommercial transactions and the section provides for a new avoidance provision. This is to be contrasted with the unfair preference provisions referred to above in Section 588FA. An uncommercial transaction is a transaction which a reasonable person in the place of the company would not enter into when taking into account benefits and detriments to the company, respective benefits to the other parties involved and any other relevant matters. Unlike an unfair preference the transaction does not have to be between the company and one of its creditors. It can be between the company and any other party. These provisions are designed to attack the disposition of assets through transactions which resulted in the recipient in receiving a gift or a bargain of such magnitude that it could not be explained by ordinary commercial practice. There are various types of uncommercial transactions. They include unfair loans, fraudulent transactions and the like. There are also numerous provisions dealing with avoiding other types of transactions including floating and other charges and also provisions dealing with recovery from Directors for insolvent trading.
- These will be subject to further papers or discussion groups.

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**G. L. PIGNONE acknowledges that the paper has been largely assisted by the book Insolvency by Andrew Keays**