Introduction: History of Insolvency Law and Identifying Insolvency

History of Insolvency Law:

Bankruptcy and insolvency law is all about collective recovery.

Bankruptcy and insolvency in Australia:

- Aus bankruptcy act is Federal
- Current act is Bankruptcy Act 1966 (Cth). Preceded by:
  - Colonial bankruptcy legislation modelled on 1869 or 1883 English legislation
  - 1924 Bankruptcy Act
- Also relevant is the Corporations Act
- Australia has separate legislative regimes for individual bankruptcies and corporate insolvency but note that prior to 1993 the relevant companies legislation = provisions of the Bankruptcy Act
- Bankruptcy of individuals → Bankruptcy Act
- Insolvency/liquidation of companies → refer largely to the Corporations Act (since 1993)
- Reviews: Clyne Report (1962) and Hamer Report (1988)

Overview of corporate insolvency proceedings:

In this course, we will look at what happens when a company becomes insolvent i.e. unable to pay their debts when they fall due.

One of the possibilities is 'formal appointment'.

- The first form of formal appointment is liquidation of the company → Winding up/liquidation
  - Parts 5.4, 5.4B and 5.5 Corporations Act
    - 5.4 – winding up in insolvency
    - 5.4B – winding up by the court
    - 5.5 – voluntary winding up
  - Winding up in insolvency is effected by the court. May end up in voluntary administration or court liquidation.
  - creditor may apply to the court order to have a company wound up to do so, they have to prove, amongst other things that the company is unable to pay their debts as and when they fall due – so this could lead to an order to wind the company up OR alternatively, creditor can apply to court to have a liquidator appointed provisionally
  - Voluntary winding up is typically triggered by special resolution of a company's members (SH). Court not involved but may get involved.
  - If you do have liquidation one of the three ways above, liquidator may recommend that the company go into voluntary administration
  - Provisional liquidation may end up in court liquidation or a creditor's voluntary winding up may result in a voluntary administration.
- Compromise or arrangement with creditors
  - Informal arrangements:
    - Moratorium – agreement by creditors to suspend their rights against debtor company in return for something. Won't bind third parties. Essentially a contractual arrangement.
    - Other possibility → May recommend a scheme of arrangement
      - Procedure under Part 5.1 of CA

        - A proposal between a company and its creditors for a compromise or arrangement to bind all creditors. Documented in a Scheme of Arrangement
    - Involves a two stage process:
        - Bankers and creditors work out possibility of compromising the claims of creditors with company directors;
        - Draft a scheme of arrangement (a plan) involving the creditors.
        - Go to court seeking to 'propound' the scheme i.e. court will see if it's in jurisdiction/power and then orders a meeting for the creditors to approve/sanction the scheme.
        - If creditors approve/vote at the meeting and goes back to court, the court orders the scheme to be effective.
- Voluntary administration
    - Part 5.3A Corporations Act
    - Voluntary administration – introduced in 1993 as an alternative to liquidation
    - Involves a process: if the directors form the view that company is insolvent, they can appoint a voluntary administrator, (which will impose a restriction on creditors taking action against that company) who will work out if the company can be rescued… administers the company in a way that maximises the changes of the company continuing in business; or results in a better return for the company's creditors than would result from immediate winding up
    - One of three things may happen – administrator may:
        - Recommend to creditors that the company enter into deed of company arrangement (DOCA) to regulate creditors rights
            - Typically involves a release by creditors in return for getting some sort of payment
        - Recommend go to creditors voluntary liquidation
        - Return to directors
- Receivership
    - Receiver may be appointed by the court or by a secured creditor
        - Appointment by a secured creditor is typically made pursuant to a power contained in the general security agreement
        - Generally trigged on event of default in that security agreement
    - Receiver, typically on behalf of the creditor, generally sells assets and pays secured creditor
    - Such a right under the security agreement is supplemented by s 420 and 420A Corporations Act
    - Court appointed receiver – last option equitable remedy (where an unsecured creditor has a concern that assets are in jeopardy but doesn't want to appoint a provisional liquidator) – equitable so discretionary – effect = put the court-appointed receiver in the position of directors. Rarely granted as it's quite an intrusion and the claimant has to give an undertaking as to damages.

<u>Objectives of insolvency law:</u>
<u>*these objectives apply equally to individual bankruptcy laws</u>

- To facilitate an orderly recovery from companies in financial difficulty in an impartial and expeditious manner
    - External administrator administers the debtor company so creditors don't take advantage of it
- To procure the orderly distribution of assets
    - pay creditors in an orderly way i.e. distribute assets in a predictable manner
- To provide a fair and equitable system of ranking claims

    - generally pari passu subject to exceptions e.g. employee entitlements have a priority to general creditors as do costs of the liquidators
    - but it's predictable
- To ascertain reasons for insolvency by debtor examinations
- To ascertain if offences have been committed
- Rehabilitation if commercially viable – rare once a company goes into liquidation
    - In case of liquidation – dissolve the company – slate/debt is wiped clean
    - In case of a bankrupt – discharge the bankruptcy – some but not ALL debts are wiped clean – note HECS debt isn't

<u>Instruments of insolvency law:</u>

- Placement of company and its assets under external management I.e. trustee in bankruptcy, voluntary administrator, receiver, liquidator, deed administrator, scheme administrator
- Suspend individual rights of recovery (i.e. once the individual or company goes into bankruptcy/liquidation/va (but not in receivership) there's a stay on actions against the individual or company) and use an impartial and expeditious collective recovery process
- Personal right against debtor is converted into a legal right to prove for a dividend on liquidation/bankruptcy
    - So there's a stay with the proof being an exception
    - So a creditor lodges a proof in the bankrupt estate and the creditor gets a 'dividend'
- Avoidance of antecedent transfers and transactions which unfairly prejudice the general body of creditors (preference or claw-back provisions)
- Statutory distribution scheme – moneys forming part of the insolvent estate are applied in a certain/particular order
    - Found in section 556 Corporations Act/section 109 of the Bankruptcy Act
- Possible sanctioning of corporate officers – typically a s588G Corporations Act action by the liquidator or by the creditor with the liquidator's consent alleging insolvent trading
- Regulated Insolvency Practitioners regime
- Regime for cross-border insolvencies
    - Where typically, a body corporate incorporated in HK or the UK gets into financial difficulties and has assets in Australia; Cross-border Insolvency Act allows the representative/UK liquidator to come to Australia and to seek recognition in this jurisdiction and that immediately a stay in these jurisdiction and enables the foreign liquidator or agent to apply our law in the winding up of the local assets

<u>Principles of Insolvency Law:</u>

- 1. Insolvency recognises pre-liquidation rights accrued under the general law – entitlements arising before liquidation are preserved and therefore insolvency respects anterior proprietary claims and therefore the rights of secured over unsecured creditors (subject to qualification), assuming that the security is otherwise valid and not subject to claw-back
    - Insolvency also recognises any countervailing equities – certain previous contractual obligations survive the insolvency.
    - Insolvency of itself does not terminate a contract or extinguish rights.
        - For example, if you as vendor enter into contract with a company who is insolvent, vendor is entitled to perform the contract and to equitable relief by way of specific performance; you have to get leave of court before you do that but insolvency OF ITSELF does not extinguish the right
        - But note ipso facto clauses which is a clause in the contract that says that insolvency may trigger termination
- 2. Only the assets of the company/bankrupt (debtor) are available for its creditors

    - Assets held by an insolvent debtor on trust are not subject to the insolvency regime (assuming the trust is properly created and not susceptible to being set aside as an antecedent transaction)
- 3. All other things being equal pre-insolvency security interests and proprietary rights (created prior to insolvency) are unaffected by the winding up/bankruptcy. Qualifications - assume that:
    - Security interest is not otherwise capable of being unwound as an unfair preference or commercial transaction
    - Security interest is otherwise perfected
        - For example, to be effective on insolvency, certain securities have to be registered on the PPSA register within certain period of time (if not, you lose security)
    - Security may be susceptible to being set aside on general law principles (from equity). If the granting of the security was associated with a breach of directors' duties to a company, the transaction can be rendered voidable in the hands of the recipient
- 4. Liquidator/trustee in bankruptcy takes the assets "warts and all" – subject to all limitations and defences
- 5. Pursuant to personal right against the debtor is converted into a legal right to prove for a dividend on liquidation/bankruptcy
- 6. On liquidation/bankruptcy, company holds its property beneficially but subject to the statutory scheme of distribution in the Corporations Act. Not a trust for creditors cf English law which says it's a trust but Aus law says it's not a trust in Commissioner of taxation v textiles)
- 7. No creditor has any interest in specie in the company's/bankrupt's assets or realisation (i.e. creditor can't point to smth in particular and say that is his asset– but can seek that liquidator complies with regime etc
    - rather the right of a creditor is not unlike the right of a beneficiary in an unadministered estate (to require the executor to comply with the terms of the will)
    - although a creditor can't point to a particular asset and claim it, it does have standing to seek orders against the liquidator to ensure that the liquidator does comply with a statutory regime
- 8. Liquidation/bankruptcy accelerates the creditor's rights to payment – can bring forth payment date
- 9. Unsecured creditors rank pari passu, subject to any security rights
- 10. Members of a company are not liable for its debts (corporate insolvency only), unless actively involved in accruing the debt i.e.: shadow directorship; s 588V shareholder of wholly-owned subsidiary may be liable for debts of subsidiary in circumstances where the subsidiary was insolvent as a consequence of an incurrence of a particular debt

Identifying Insolvency:

Definitions:

- S 95A(1) Corporations Act: 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**
- 95A(2); a person who is not solvent is insolvent
- **the test is essentially a cash flow test**

Relevance of insolvency in corporate insolvency:

- Appointment of voluntary administrators (Pt 5.3A – section 436A)
    - Directors have to form the view that the company is insolvent (s95A test)
- Winding up applications (Pt 5.4)
    - As part of the application to the court, you have to prove that the company is insolvent (s95A test)