

# V: CORPORATE INSOLVENCY

## Chapter 5 Corporations Act: External Administration

In Australia, our insolvency model is an **external administration model** i.e. administration or control of company affairs is taken from the company's directors and put into external hands

- In insolvency, the external administrations, not the board, are in control

## FEATURES OF CORPORATE INSOLVENCY LAW

### Definition of insolvency

#### What is insolvency?

- **Insolvency:** the inability to "pay all the person's debts, as and when they become due and payable": s 95A

When assessing insolvency:

- **Debt** includes all claims, whether liquidated or not and whether due, prospective or contingent: *Bank of Australasia v Hall*
- **Debts 'due and payable'**: necessary to take into account debts that will be due "in the immediate future": *Bank of Australasia v Hall*
- **'Unable to pay' debts**: a company is **not insolvent merely because it does not have sufficient funds on hand to meet its debts**
  - Funds that can be raised by the company can be taken into account e.g. through sale of its assets, trade allowances

### The role of registered company liquidators

#### Provisional Liquidators

- **Court may provisionally appoint a liquidator** to a company **after a winding up application** has been made out but **before the application is heard**: s 472(2)
- **Role:** preserve the status quo to ensure the least possible harm to all concerned and to enable the court to decide, after a further examination, whether the company should be wound up.

#### Liquidators

- Before a person can be registered as a liquidator or a provisional liquidator, they **must be registered with ASIC**: s 532
- An **official liquidator** is a **registered liquidator with prescribed experience (at least two years' continuous experience in insolvency administration)** as a liquidator
- A **liquidator appointed by the court must be an official liquidator** whereas a **liquidator appointed by members or creditors in voluntary winding up must be registered but need not be official liquidators**: ss 472(1) & (2); s 532(8).

#### The duties of liquidators

- **Notifying ASIC of their appointment** as a liquidator: s 537
- **Lodging a preliminary report with ASIC** concerning the **company's financial position and whether the liquidator considers that further inquiry is necessary**: s 476
- **Lodging a report if unlawful conduct** is uncovered in the course of the liquidation;
- Stating **whether an examination is necessary** where creditors are expected to receive less than 50c in the dollar: s 633
- **Keeping proper books and records**: s 531
- Lodging with ASIC an account of receipts and payments and 6 monthly statements on the progress of the liquidation: s 539

NB: shareholders don't get to control the liquidator

## ASIC's role in external administration

- Regulate the profession, ensuring independence, competence and reasonable remuneration
- Education and guidance (information sheets, regulatory guides, stakeholder engagement)
- **Surveillance** activity
- **Enforcement** activity (court, undertakings, auditor's and liquidator's disciplinary board)
- Can **appoint a receiver**: s 1323(1)
- **Recommends** that the company be **wound up**: s 461(1)(h)
- **Take action against directors** who allow the company to trade whilst insolvent: s 588G
- Publishes notices and reports relating to insolvency

## Stay against claims

If a company is insolvent, creditors won't be paid in full. As such, well-funded creditors who perceive signs of insolvency will try to go to the court to get their sum paid before anyone else. Staying prevents any benefits accruing to any specific investor(s)

Type of external administration	STAY OF ENFORCEMENT	STAY OF PROCEEDINGS
<b>Voluntary administration</b>	<ul style="list-style-type: none"> <li>• <u>Except with leave of the Court</u>, <b>no enforcement</b> process in relation to the <b>property of the company can begin or proceed</b>: s 440F</li> <li>• <b>Secured parties may exercise their property rights</b> <u>in specified circumstances</u></li> </ul>	A party requires the <b>administrator's written consent or leave of the Court to begin or proceed</b> with "proceeding in a court" <b>against the company or in relation to any of its property</b> : s 440D
<b>Winding up</b>	<ul style="list-style-type: none"> <li>• <u>Except with leave of the Court</u>, a <b>person cannot begin or proceed</b> with an <b>enforcement</b> process in relation to the <b>property of the company</b>: s 471B</li> <li>• <b>Secured creditors retain their right to realise</b> or otherwise deal with their <b>security after winding up</b>: s 471C</li> </ul>	<b>No "action or other civil proceeding"</b> or "proceeding in a court" is to be proceeded with or <b>commenced against the company or in relation to property of the company</b> <u>except by leave of the court</u> : ss 471B & 500(2)

## Pari passu distribution

- The **assets of a company** in insolvency are **equally distributed between creditors** during a VA, liquidation or other restructuring
- The **pari passu rule** **applies to creditors who do not have a secured interest in the company's property** beyond any other creditor
- After secured creditors have their debts repaid, the **remaining creditors have the remaining assets distributed among them equally and proportionally**.

## OVERVIEW OF EXTERNAL ADMINISTRATION

There are **several types** of external administration:

- (1) **winding-up (liquidation)**: selling all the company's assets and paying the proceeds to creditors and deregistering the company
  - Made either upon the order of the court (compulsory liquidation) or by voluntary decision of a company's members or creditors
- (2) **receivership**: **secured creditor** (or court: s 1323) **appoints** an external administrator as a **receiver**, **to take possession of the secured property** and
  - (i) **sell it to repay** the secured debt; or
  - (ii) **manage the business until the risk** posed to the security can be **removed**
- (3) **voluntary administration**: **administrator** (registered liquidator) appointed to **investigate company's financial position and decide on a course of action** that's **in the best interest of creditors**: s 438A
  - During administration, the administrator has control of the company's property and business whilst the directors powers are suspended

- (4) **creditors' scheme of arrangement:** a company in financial difficulty engages in a **procedure to reorder its affairs and come to an arrangement** that will **bind all of its creditors**
- **Procedure:** application to court → meeting held → **scheme binding if approved by majority of creditors (75%) and court: s 411(4)** → lodge court order with ASIC: s 411(10).

**Order of payment in winding up: s 556**

- (1) The **costs of liquidation**
- (2) **Secured creditors** paid first
- (3) **Priority unsecured creditors:**
  - (a) **Liquidators** fees and expenses
  - (b) **Employee entitlements** for wages, superannuation contributions, claims for injury compensation and retrenchment
- (4) Remaining **unsecured creditors** have the **remaining assets distributed** among them **equally and proportionally: pari passu rule (s 555)**
  - Creditors are paid an equal proportion of the debt they are owed
- (5) Surplus funds distributed among **members** (often none, as insolvent company cannot pay its debts)

Note that you can have multiple insolvency practitioners appointed at the same time

## Receivership

### Pt 5.2 Corporations Act

The outcome is to preserve the secured assets and to return to normal treating or to sell assets/commence liquidation

- Typically involves a **secured creditor** (normally a bank, finance company, or trustee acting on behalf of debenture holders) **appointing an independent person, the receiver, to take possession of the secured property** and either:
  - **sell it to repay the secured debt;** or
  - **manage the business until the risk posed to the security can be removed** (for example, by restructuring the business)
- When a secured lender appoints a receiver of the company's property, the company's ability to deal with the secured property is restricted
- "receiver" vs. "receiver and manager"
- Court also has power to appoint upon application by ASIC or an "aggrieved person": s 1323
- Powers (see full list in s 420): a receiver strictly has only power to receive property and income and not to undertake the management tasks such as asset disposal that may be necessary for this purpose

	Liquidation	Receivership	Voluntary Administration	Creditor's Scheme of Arrangement
<b>Initiation</b>	Court order (compulsory liquidation) on the grounds of insolvency: s 459A  Members or creditors (voluntary liquidation) <ul style="list-style-type: none"> <li>- Members: company must be solvent and special resolution must be passed: s 491</li> </ul>	A receiver is usually appointed by a secured creditor, but court can appoint too upon application by ASIC or an "aggrieved person" (s 1323) to take possession of the secured property	Directors (s 588H (5) & (6)), liquidator or secured creditor with security over all or substantially all of the company's assets	Credits and the company

	- Creditors: company must be insolvent			
<b>Process</b>	<p>Liquidator takes possession of the company's assets: s 478(1)</p> <p>Investigates why company failed</p> <p>Reports to ASIC on potential breaches of the law</p> <p>Determines what debts are owed</p>	N/A	<p>VA tries to save the company's business, or provide a better return than liquidation</p> <p>VA (registered liquidator) investigates affairs of the company and its financial position, and reports to creditors. VA needs to advise creditors as to what they should vote on at the final meeting</p> <p>Decides on a course of action that's in the best interest of the creditors: s 438A</p>	<p>Company engages in a procedure to reorder its affairs and come to an arrangement that will bind all the creditors</p> <p>Two court approvals are necessary</p> <ol style="list-style-type: none"> <li>(1) To convene creditor's meeting</li> <li>(2) To approve scheme approved by majority of creditors (75%): s 411(4)</li> </ol> <p>Court order is then lodged with ASIC: s 411(10)</p>
<b>Impact on unsecured creditors</b>	<p>Moratorium against claims without liquidator or court permission: s 471B</p> <p>Creditors have a <b>right to lodge a claim with the liquidator</b> (called a proof of debt) <b>to attend and vote at creditor meetings and to receive a share of the contributions made by the liquidator</b></p>	No moratorium	<p>Moratorium during administration against claims and court proceedings without VA's written consent or leave of the court: s 440D</p> <p>NB: winding up application stayed</p> <p>NB: moratorium ends after 2<sup>nd</sup> meeting of creditors (subject to DOCA)</p>	Bound by provisions of scheme if creditor and court approved
<b>Impact on secured creditors</b>	None – secured creditors retain their right to realise or otherwise deal with their security after winding up: s 471C	Junior secured creditors will need to wait until the end of the receivership by senior secured creditor to recover	<p>Stay against claims during administration applies to secured creditors</p> <p>Bound by moratorium after the decision period. VA restricted in disposing of property subject to security</p> <p>Exceptions: person with a security interest <b>over</b></p>	None
				However, scheme can bind secured creditors

			the whole or substantially the whole of a company's property who has that security interest perfected (i.e. registered) within the meaning of the <i>PPSA</i> may take enforcement action before appointing an administrator: s 441A	
<b>Impact on owners/lessors</b>	None – liquidator doesn't control property owned by others  May prove in winding up for unpaid rent/lease costs	None	Bound by moratorium, unless court or VA give permission to retake possession.  VA liable for rent after 5 business days	May be bound by scheme depending upon the scope of the scheme document
<b>Duration</b>	May take years	May be quick or long depending on the risk to the assets	Meant to be a short process (approx. 6 weeks) although a DOCA usually takes years to work through	Depends on the time specified in the scheme document
<b>Outcomes</b>	Selling company's assets and distributing these to creditors in order of statutory priority company's assets  Deregistration of company	Preservation of secured assets and return to normal trading or sale of assets and liquidation	Creditors may vote for: (1) DOCA (deed of company arrangement) <ul style="list-style-type: none"> <li>➤ Won't prevent secured creditor or property owner enforcement (unless they consent to voting for the DOCA)</li> <li>➤ Can be varied or set aside by court</li> </ul> (2) Creditors' voluntary liquidation (3) End of VA and return to trading	Specified in the scheme document
<b>Powers</b>	Liquidators have more power than any other external administrator  Manage the company's affairs: s 477	Receiver takes possession of the secured property  Receivers over all assets usually have management power	VA has full management powers (s 437A) and can replace director, sell assets <ul style="list-style-type: none"> <li>- Directors powers are suspended</li> <li>- VA has control of the company's property</li> </ul>	N/A

	<p><b>Take and defend legal action</b> on behalf of the company, including the ability to sue directors for insolvent trading and to recover voidable transactions: s 477; s 588G</p> <p><b>Reclaim property sold by company</b> prior to liquidation under the voidable transaction provisions: Pt 5.7B, Div 2</p> <p><b>Disclaim onerous property or contracts:</b> s 568</p>	<p>Receivers and managers control the management of the company, even if a liquidator or VA is appointed</p> <p>Privately appointed receivers have a duty to protect the appointing creditor's security</p> <p>Company's ability to deal with the secured property is restriction</p> <p>Directors powers are displaced but only to the extent of inconsistency with receiver's powers</p>	<p>NB: court has flexible powers to alter operation of voluntary administration: s 447A</p>	
<b>Advantages</b>	Powers relating to voidable transactions and insolvent trading	Receiver generally acts in the best interests of appointing secured creditor	Quick and extensive moratorium give company chance to recover	Highly flexible
<b>Disadvantages</b>	Lengthy and expensive, which may offer lower return than VA	No moratorium	<p>Possibly too quick to implement best restructure</p> <p>May be open to abuse by directors seeking to avoid scrutiny in liquidation</p>	Slow, complex and expensive due to multiple court applications and class voting requirements

## DEFENCES

### **Defences to insolvent trading** **s 588GA "Safe Harbour" Defence**

Provides protection to a **director who** (s 588GA(1)):

- (1) at the time when the debt is incurred,
- (2) suspects the company may become or may be insolvent, and
- (3) **starts developing** one or more **courses of action** which are **reasonably likely to lead to a better outcome for the company than an immediate appointment of administrator or liquidator**

Directors bear an **evidential burden** to establish that the safe harbour applies: s 588GA(3)

### **Limitations**

Defence only applies to debts incurred (s 588GA(4)):

- (1) directly or indirectly in connection **with developing or taking the course of action,**
- (2) **during the period commencing when the course of action is first taken and ending the earliest of:**
  - (a) the end of a reasonable period after a director starts to suspect company's insolvency if director fails to take required course of action within that period; or
  - (b) when the course of action ends; or
  - (c) when the course of action ceases to be reasonably likely to lead to a better outcome; or
  - (d) when the company enters into administration/liquidation.

Defence won't apply where directors fail to do the following and such a failure amounts to 'less than substantial compliance' or is one of 2 or more failures in the past 12 months: (s 588GA(4))

- Employee entitlements are not paid on time e.g. superannuation
- ATO returns, notices, statements applications or other documents as required by taxation laws are not provided (i.e. lodgements, not payments, aren't provided)
  - RATA forms not supplied
  - Officers refuse to hand over company books to liquidator (s 588GB)

***Is the course of action reasonably likely to lead to a better outcome for the company?***

Is the director (s 588GA(2)):

- (a) properly informing himself or herself of the company's financial position; or
- (b) taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all its debts; or
- (c) taking appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company; or
- (d) obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; or
- (e) developing or implementing a plan for restructuring the company to improve its financial position.

***Better outcome*** could take into consideration:

- (i) The effect on the company's creditors;
- (ii) The ongoing employment of staff;
- (iii) The flow-on effect to suppliers and customers;
- (iv) The public interest; and
- (v) The effect on other related entities and stakeholders.

### **s 588H Defence**

- **Reasonable grounds to expect (and did expect)** that the company was solvent and would remain solvent even if the debt/other debts incurred: s 588H(2); *Hall v Poolman*
  - The term "expects" imports a higher degree of certainty than "mere hope or possibility" or "suspecting": *Tourprint International Pty Ltd (in liq) v Bott*
  - D justified in expecting solvency if an asset could be realised to pay accrued and future creditors in full within about ninety days: *Hall v Poolman*
  - Cannot base an expectation on solvency upon the prospect that the company might trade profitably in the future thereby restoring its financial position: *Powell v Fryer*
- **Reasonable reliance on the information from a reliable person** who was responsible for providing information to the director: s 588H(3); *McLellan v Carroll*
  - In reality this seems to require ongoing monitoring and review – won't protect passive directors acting without scrutiny
  - Obligation on director to find out whether an inconsistency exists
- **Justifiable non-participation** (illness or some other good reason): s 588H(4)
  - Not enough to be blindly reliant on husband: *DCT v Clark*
- **Reasonable steps taken to prevent incurring of a debt**: s 588H (5) & (6)
  - E.g. resigning, voting against transaction, appointing administrator or external consultant

### **Safe harbour: s 588GA**

*Corporations Act 2001 s 588GA: Safe harbour – taking course of action reasonably likely to lead to a better outcome for the company*

*Safe harbour*

- (1) Subsection 588G(2) does not apply in relation to a person and a debt if:
  - (a) at a particular time after the person starts to suspect the company may become or be insolvent, the person starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company; and
  - (b) the debt is incurred directly or indirectly **in connection with any such course of action** during the period starting at that time, and ending at the earliest of any of the following times:
    - (i) if the person fails to take any such course of action within a reasonable period after that time—the end of that reasonable period;
    - (ii) when the person ceases to take any such course of action;

## Justifiable non-participation

*Deputy Commissioner of Taxation v Clark* (2003) 57 NSWLR 113

- **Ratio:** every director is expected to participate in the management of the company

<b>FACTS</b>	<ul style="list-style-type: none"><li>- Involved a family company with 2 directors who were husband and wife (Mr and Mrs Clark)</li><li>- Mrs Clark did not take part in the management of the company and relied on her husband to manage the business</li><li>- When the company got into financial difficulties, a payment was made to the Commissioner of Taxation<ul style="list-style-type: none"><li>• This payment was then reclaimed by the company's liquidator as an unfair preference</li><li>• The Commissioner of Taxation may seek an indemnification from company directors when their company's taxation payments are reclaimed as unfair preferences<ul style="list-style-type: none"><li>○ The defence to this indemnification provision is s 588FGB which is in the same wording as s 588H (defences to insolvent trading)</li><li>○ The trial court held that Mrs Clark had a defence under the equivalent of s588H(4) by relying upon her husband and not taking part in the management of the business for "good reason."</li><li>○ The Commissioner appealed.</li></ul></li></ul></li></ul>
<b>ISSUE</b>	Did Mrs Clark's reliance on her husband constitute failing to take part in the management of the company for "some other good reason" as required under the equivalent of s 588H(4)?
<b>HELD</b>	<ul style="list-style-type: none"><li>- <b>Mrs Clark could not avoid liability on the basis that leaving the business to her husband was "some other good reason."</b></li><li>- The court held that the provisions must be read within a broader context of legal expectations that directors will take an active part in managing or monitoring the management of the business<ul style="list-style-type: none"><li>• This means that a total failure to participate, for whatever reason, should not be regarded as a "good reason" for failing to participate at a particular time</li></ul></li><li>- Blindly delegating power and responsibility to another person would not satisfy this duty.</li></ul>