2017/18 Guide to

Corporate Insolvency

WORRELLS

SOLVENCY + FORENSIC ACCOUNTANTS

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Foreword

Always inspired to focus on the advisor and client position

We could dedicate this Foreword to giving our comments on the upcoming insolvency law reform on both its finite and potential consequences on the marketplace.

We considered this angle by listing all the pieces of reform that has been dissected, deliberated, and debated within the industry. We stared at the list that unfolded and acknowledged that yes—it will change the game, and as innovators ourselves we certainly hope innovation in the industry emerges. But we readily acknowledge that we're not inspired to speak on the reform through this forum.

We are, however, inspired to connect with our professional colleagues in more meaningful dialogue.

So, rather than looking to the macro environment, we're looking at the micro environment. Rather than commenting and illuminating on how the reform will carve out a new shape on the insolvency *landscape*, we chose to focus on the *portrait* of the people who find themselves in this environment.

We believe this focus is grounded in building meaningful connection with you, the reader of our Guide to Corporate Insolvency.

Foreword

So, what does the Worrells' portrait of you look like?

Repeatedly, professional advisors find themselves in a tough position and in need of credible and helpful answers to insolvency challenges, as and when they happen. We know that advisors are expected to promptly 'zone in' into the crux of a technical question or quandary, relevant to a client's circumstances. We know advisors are expected to have 'the big picture' and traverse the series of questions that flow: as one question is answered, another is uncovered. We know the perturbed, emotionally charged energy that flows between client and advisor as each party look to each other in search for answers and understanding.

We know it. We get it. And we want to help.

One way we try to help is by investing in developing and producing this Guide you're reading right now.

Long-time users may have noticed how the Guide has evolved since its inception in 2009 in all its forms: black and white, passport photos of our partners, to full colour, head-to-floor model shots. We have employed different features, checklists, editorials, and local commentary to breathe life into our value propositions we give the market, by using *Plain Talk*, offering *Straight Answers*, and giving *Fast Results*. We also create state editions of our Guides to Insolvency to show you that we are *focused locally, but resourced nationally*.

One aspect of our Guides to Insolvency that remained unchanged over the years is the structure of two sections—one to give the main facts of each insolvency topic in Q&A style (giving straight answers, in plain talk to technical insolvency questions), and two—to market ourselves (demonstrating our insolvency expertise and knowledge).

This year we offer you a unified Guide. No sections, no delineated or cross purposes underpinning its layout. One Guide, one subject at a time, with all the main information in that one place. We hope it helps you uncover whatever the question is, in that moment of having to 'zone in' to your client's question. We hope it helps build the 'bigger picture' as the discussions with your client develops. We hope it gives you some assurance.

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As always, we're here to help. And we want to work through the insolvency challenges with you to get credible and helpful solutions.

CORPORATE ADMINISTRATION TYPES

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CASE STUDY

The strange case of 'We Buy Any Car': Collateral damage of $9.8m hidden by an illusion of success

We can help advisors find the truth behind the numbers.

This is the atypical case of a company trading as 'We Buy Any Car' that lost no less than $9,848,090 in 12 months. This incredible company debt equates to an *average* loss of over $175,000 for every week of trade. The company directors, appointed Worrells as liquidator under a creditors' voluntary winding up in July 2012. And one of the two directors promptly left the country.

Trade creditors, staff, and vehicle sellers unwittingly contributed over $5 million of company debt. Seven hundred and one creditors lodged a proof of debt in the winding up. A handful of creditors even took matters into their own hands when they tried to take back the vehicle they sold.

The fallout and the lengthy and in-depth investigations that ensued from this company's liquidation to find the truth behind the numbers, could supersede the length of this Guide you're reading, so we offer this Case Study as a snapshot of what went wrong.

From the outset of our appointment, we were confounded by a significantly atypical business structure and trade, which challenged our widely-held perception of fundamental business acumen, namely:

- Most businesses start with limited working capital—this company was flooded with $6 million, interest-free, without security, and without requiring any business performance reporting.
- Most businesses gradually increase turnover over many years—this company was trading high volumes within the first six months of opening.
- New business owners can be inexperienced or need more technical knowledge—one director had 35 years' experience in the industry, was previously a director for a company with a turnover of $90 million plus annually.
- Most directors that enter a partnership, know each well and are convinced of business compatibility—the two directors were all but strangers.
- For most businesses, each sale adds to its profits or reduces it losses—each sale consistently increased losses.
- While many businesses fail due to a lack of budgeting or adequate bookkeeping, nevertheless, most at least, make a reasonable attempt at these business elements—planning was non-existent and its accounting totally useless. The directors never had the slightest idea of the business's financially position.

Have these observations got your attention? It certainly evoked a relentless search of the truth in the years that followed.

Business model

We understand that the intention was for this business to follow a successful example of a similar operation in the United Kingdom (see: webuyanycar.com). Despite the company extensively using and promoting the name "We Buy Any Car", at no time was that name owned or registered or any party connected with the company.

Under the 'We Buy Any Car' value proposition, people could sell their car to the company, for an agreed price (based on red book value and personnel discretion), and be paid within 10 days—regardless of whether the car was resold or not. We Buy Any Car then on-sold these vehicles through an auction house.

The business marketing hinged off extensive television, internet, and other media advertising to encourage people to sell their vehicle to 'We Buy Any Car'. We found that it spent around $5.5 million on this marketing, which across the 7,300 vehicles purchased equates to over $758 per vehicle. Given this business model was unique in Australia, there are no industry statistics to compare this expenditure with. The investment in marketing so was so great that when the advertising agency tried to collect its debt—$952,000 (described as "extraordinarily large" by the agency's director)—it was a principle catalyst in the We Buy Any Car directors resolving to wind up the company.

Company funding

The company was *substantially* funded by a series of large, interest-free and unsecured advances by one of the directors (through his separate company). The company's claim over a loan account of $6,064,839 was admitted into the winding up.

Company shares were issued at $1.00 each. That is, the company only ever had funds of $200 of its own, and therefore relied entirely upon loans and credit from trade suppliers, and credit from those selling cars to the company, for its working capital. Minor income was also received from related trading activities such as finance commissions.

Cash flow was maintained through one main trade creditor: an auction house that advanced payments equal to 90 percent of each vehicle's value sent to auction. A $150 fixed fee was charged per vehicle being auctioned plus transport and detailing disbursements. As an aside, the auction house offered a reduced auction cost if a certain number of cars were sold, which was never reached due to the winding up. Given the nature of buying and then on selling vehicles, a "back to back" purchase and sale (self-funding) was intended. Some 7,300 vehicles were traded over its 12-month business, which equates to an average of 150 per week.

We understand that a target gross profit of $850 per vehicle was set. The actual result achieved was an average of only $117 per vehicle (14 percent of the target set). The three principle overheads of marketing, web development, and staff-related costs amounted to over ten times the actual gross profit made.

So, let's crunch the numbers, hypothetically, as no records reflect the principle underpinning the We Buy Any Car business model.

Acquisition cost (We Buy Any Car marketing)	$758
Vehicle auction fixed fee	$150
Auction costs: transport and detailing (estimate)	$100
Total on sale cost	$1,008
Vehicle purchase (average)	$5,000
Required vehicle auction sale	$6,008
Actual sale amount	$5,117
Average loss on vehicle sale ($5,117 - $6,008)	$891

Liquidation

Worrells' main findings

At the start of the winding up, we found drastically incomplete and unreconciled accounting records. We reconstructed the accounts and reported to creditors:

- While substantial expenses were incurred to reconstruct the accounts, we identified significant recoverable assets to meet administration costs and submitted an extensive report to ASIC concerning the company affairs (section 533 of *Corporations Act 2001*).
- That unsecured creditors were owed no less than $11,507,436 (being $6,064,839 loan account debt and $5,442,597 due to other creditors).
- Of the 629 We Buy Any Car vendors (customers) that were not paid for their vehicles, 93% sold their vehicle in the last two months of trade. Their claims totalled $2,624,844, which averages at $4,173 per customer.
- Over $1.7 million was spent on information technology and website development; however, no element was saleable or could otherwise contribute to the return due to creditors.
- We found several instances of vehicles being paid for twice or for more than the amounts due:
  - Over $120,000 was lost in duplicate payments over 41 vehicles.
  - 22 vehicle vendors were overpaid to the extent of over $58,000.
- Records show the directors had been negotiating with a potential investor who, after conducting their due diligence, withdrew their interest.
- The series of unsecured advances were largely used to pay debts already incurred rather than to fund future trading. The advances were accounted for as follows:

Vehicles transferred prior to start up	$2.295m
Start-up trade expenses paid by related company	$1.569m
Advances throughout trading period	$7.528m
Funds Repaid throughout trading period	($5.327m)
Balance owing to related company	$6.064m

- We established an insolvent trading claim of $4.9m.
- We held a public examination of the two directors, some employees, the ex-bookkeeper, and some creditors.

Director—missing in action

The director that absconded the country prior to the winding up attended the public examination via video link from the UK, said he intended to return to Australia but stayed due to threats he said he received and because of what he described as "*the media circus*". He stated at the public examination that he had "*no access to administration or accounts*" and further that he "*was just solely focused on the sales*".

He also gave evidence that he never sought nor received any advice regarding his duties as a director of an Australian company. He said that he was paid an annual salary of $150,000 plus superannuation and had use of two vehicles.

Despite our approaching the relevant authorities for his extradition, almost five years later this director has not returned to Australia.

Preferential payments

To sustain cash flow and the 'back to back' self-funding premise, the advances made for potential auction sales were held as an undertaking and subsequently registered as a security by the auction house's financial associates.

Shortly prior to our appointment, this auction house retained the latest vehicle sale proceeds (balance from an advance). The legal advice we obtained said that it was likely a court would find their security invalid—lodged 25 days before our appointment—and that as an unfair preference payment a court would order the $1,035,712 retained under its security be distributed back to us as the liquidators. We commenced litigation to seek full recovery of the $1,035,712. In view of the argued defences lodged, we reached a settlement of $400,000, which was a commercial decision that avoided potentially lengthy and expensive court action.

Insolvent trading claims

Our investigations determined that We Buy Any Car was either insolvent from inception due to inadequate financial records kept as required under section 286(1) of the Corporations Act and alternatively as at April 2012 under section 95A.

We sued the non-absconding director for the $4.9m insolvent trading claim, which he vigorously defended (at substantial expenses to him). A court-ordered mediation was unsuccessful, and on the eve of a lengthy trial we finally agreed to a settlement amount of $600,000. Given we held no funds in the liquidation and none of the corporate creditors were prepared to fund litigation, our legal counsel advised that commercially it was in the administration's best interest to accept the settlement offer on the terms that this director (and his respective companies) subordinate their $6,213,740 claim behind the other creditors in the liquidation.

We pursued the other director (who absconded the country) with a demand and were unable to locate any significant assets (in the UK or elsewhere). Again, any further expenses would need to be in the creditors' best interest, which rendered further action uncommercial.

Conclusions

Again, our reports to creditors and our confidential report (section 533 Corporations Act) submitted to ASIC supersede the length of this Guide to Insolvency, so we outline our main reasons for why this company failed.

- The directors did not act cohesively for the greater part of the company's trading life and individually, they had an extremely limited understanding of the company's actual trading profile, the worth of its assets and the value of its liabilities.
- At no time, did the directors possess meaningful accounting or management reports, or indeed that the accounting records could produce such reports.
- Lack of business control led to vehicles being bought and sold with less than adequate margin and incurred of certain costs at unsustainable levels.
- Overall only a limited gross margin was achieved and that extensive marketing and other administration costs were incurred leading to losses being recorded.
- Many dealers were slow to pay for vehicles supplied, which hindered the 'back-to-back funding' model.
- The marketing campaign was so successful that nine months into 12 months of trade, insufficient vehicle wholesalers were willing and able to purchase the number of vehicles being sourced.

This liquidation was certainly confounding and challenged us, as insolvency practitioners, of just how directors and key personnel could be willingly enabled to 'drive blind'—not just initially when the business started up, but consistently over its 12-month life. Individually and collectively, the directors and employee's sustained efforts to build this business, actively and ignorantly contributed to a weekly loss, on average, of over $175,000 that accumulated to a net loss of $9,848,090 in just 12 months. Each sale of the 7,300 vehicles We Buy Any Car sold: consistently increased losses.

Particularly, when the directors had expert knowledge about cars and was steeped in motor vehicle trading. And one director had a 35-year career in the industry and was previously a director for a company with a turnover of $90 million plus annually.

It seems somewhat fitting that the very thing that underpinned its *illusion* of success was the business marketing, which that forced the directors to end the collateral damage and resolve to wind up the company when the advertising agency demanded payment of their $952,000 account. It seems that proverb "things aren't always what they seem" is apt to discern the *illusion* from the *reality* of this business. Whether a business is in the start-up phase, or in the decline phase, Worrells can offer our understanding and experience from various business models, structures, and industries to help advisors find the truth behind the numbers.

What is liquidation?

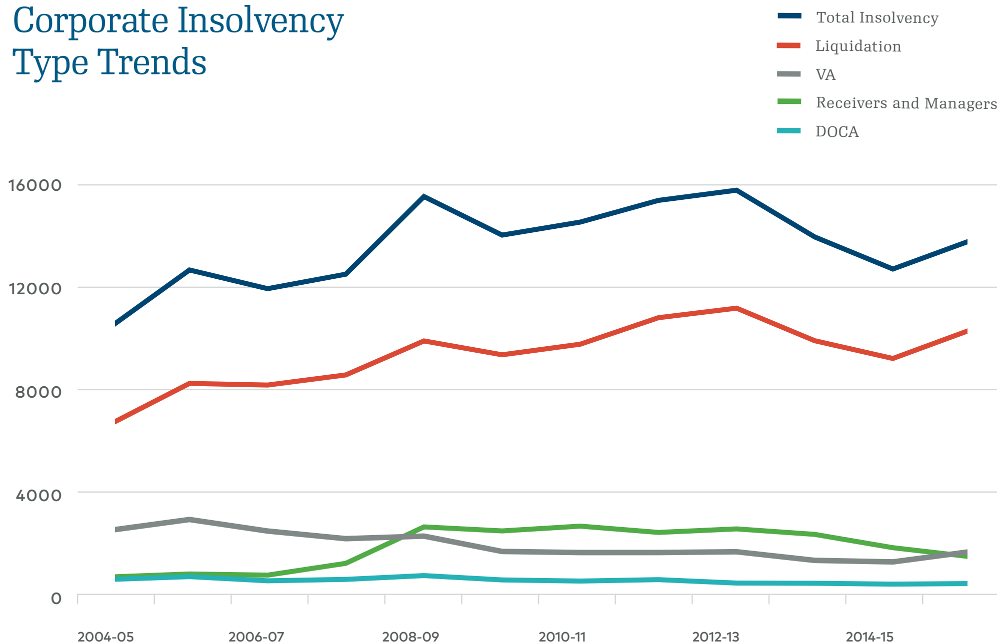
Liquidation is the process of winding up a company's financial affairs to dismantle the company's structure by conducting appropriate investigations and enabling a fair distribution of company's assets to its creditors. Liquidation occurs either because the company cannot pay all of its debts (i.e. it is insolvent), or its members want to end the company's existence and have it struck off from the Australian Securities and Investments Commission's (ASIC) register.

WHY CHOOSE LIQUIDATION?

Liquidation is the only way to fully wind up the affairs of a company and end the existence of the company. An independent party undertakes the process and protects the interests of creditors, directors and members while the company structure is dismantled.

HOW CAN AN INSOLVENT COMPANY BE WOUND UP?

An insolvent company can either be wound up by the court, usually by one or more creditors making an application to the courts, or voluntarily by resolution of the company directors and, if appropriate, the company members at a relevant meeting.



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WHAT IS A COURT LIQUIDATION?

The applicant must demonstrate to the court that the company is insolvent or can be deemed to be insolvent. The court will then appoint a liquidator, usually one nominated by the applicant (creditor). The court may also wind up a company when there are irreconcilable disputes between shareholders or directors, or for a limited number of other reasons.

WHAT IS A VOLUNTARY LIQUIDATION?

A voluntary liquidation is a process whereby the company voluntarily appoints a liquidator. Creditors have the right to change the appointed liquidator at any time. A voluntary liquidation can occur by a creditors' voluntary winding up or through voluntary administration.

WHAT IS A MEMBERS' VOLUNTARY WINDING UP?

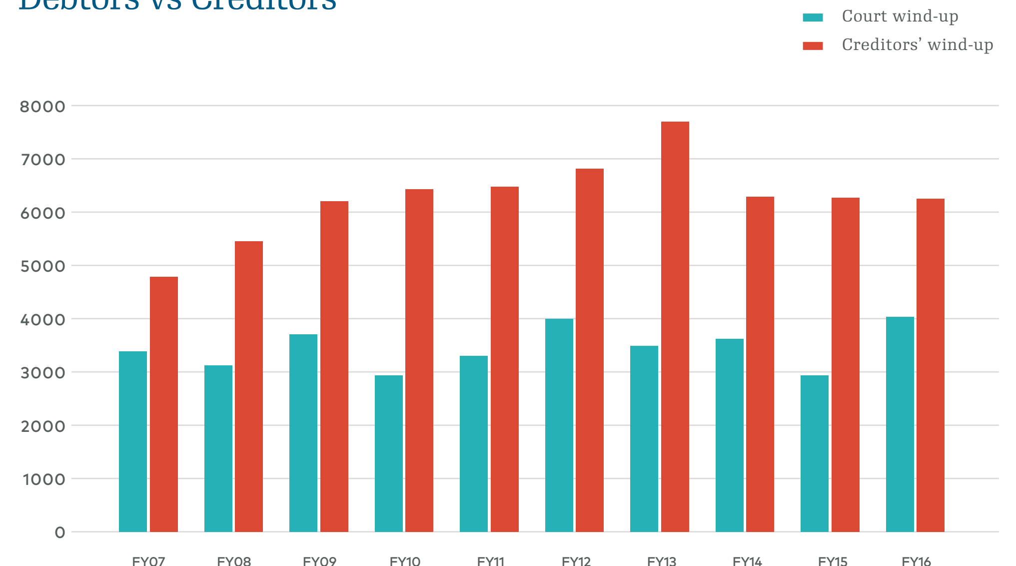
A members' voluntary winding up is the process for members who wish to dismantle the company structure. Usually the company will be solvent, and a members' voluntary winding up is chosen as the company has no useful future.

MORE INFO:
MEMBERS' VOLUNTARY WINDING UP P30

WHAT IS A CREDITORS' VOLUNTARY WINDING UP?

A creditors' voluntary winding up is a process where the directors determine that the company is insolvent and resolve to place the company into liquidation and they appoint a liquidator. A meeting of creditors is held within 18 days (with an 11-day convening period and a 7-day notice period) of the resolution to wind up the company. At this meeting, the creditors have the opportunity to change the liquidator.

A creditors' voluntary winding up is commonly used when a company is insolvent and a Deed of Company Arrangement (DOCA) is not possible and the company simply needs to be liquidated. If a wind-up application has been filed with the court, or if the court has ordered that company be wound up, a creditors' voluntary winding up is not possible.



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VOLUNTARY ADMINISTRATION

A company can also be wound up voluntarily through the voluntary administration process. The directors resolve to appoint voluntary administrators to the company.

A resolution of the members is not required. After the resolution is passed the administrators who consented are then appointed. A meeting of creditors is held within eight days of the appointment of the voluntary administrator. At this meeting, creditors have the opportunity to appoint alternative administrators.

After the first meeting, the voluntary administrators conduct investigations into the company and issue a detailed report pursuant to section 439A of the *Corporations Act 2001*. This report outlines the investigation's findings and the available options for creditors regarding the company's future.

The options available to creditors are:

- to accept a DOCA, if one is proposed
- to place the company into liquidation
- to end administration and hand the company back to the directors.

A second meeting of creditors is held to consider these options. Voluntary administrations are geared towards a company that wishes to put up a DOCA; however, there are circumstances where it may be appropriate to place a company into liquidation, for example:

- winding-up proceedings are underway and therefore the creditors' voluntary winding-up process is not an option
- the business is continuing to trade whereby it is more appropriate or advantageous for a voluntary administrator to manage ongoing trade
- a DOCA is being considered

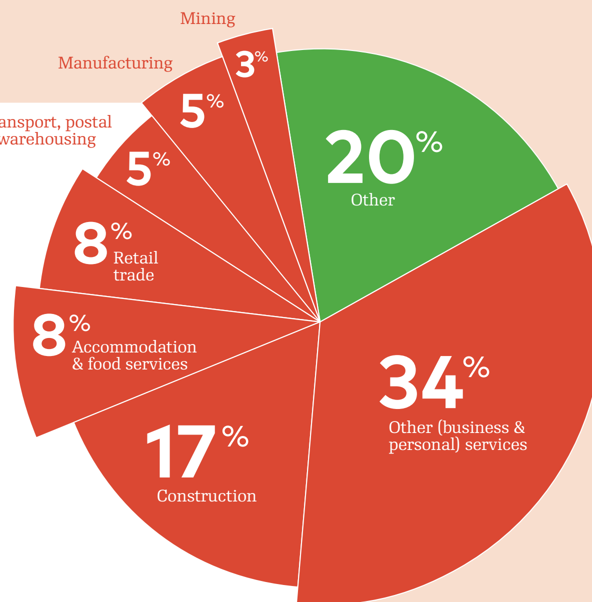
Typically, the voluntary administration process is more expensive due to the increased work involved. In most cases the creditors' voluntary winding up process is a more appropriate method of the voluntary appointment of a liquidator.

The liquidation process is almost identical, regardless of how it is started.

MORE INFO:
VOLUNTARY ADMINISTRATION P18

Corporate Insolvencies by Industry Type

TOP 7 INDUSTRIES	
Other (business & personal) services	34%
Construction	17%
Accommodation & food services	8%
Retail trade	8%
Transport, postal & warehousing	5%
Manufacturing	5%
Mining	3%
OTHER INDUSTRIES	
Unknown	3%
Rental, hiring & real estate services	3%
Information media & telecommunications	2%
Agriculture, forestry & fishing	2%
Electricity, gas, water & waste services	2%
Wholesale trade	2%
Finance & investment services (FIS)	2%
Professional, scientific & technical services	2%
Arts & recreation services	1%
Health care & social assistance	1%
Administrative & support services	<1%
Education & training	<1%
Public administration & safety	<1%



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The liquidation process is almost identical, regardless of how it is started.

HOW DO YOU PROVE THAT A COMPANY IS INSOLVENT?

A company is insolvent if it cannot pay all of its debts as and when they fall due, even if the company has an asset surplus but no way to liquidate those assets quickly. A company is deemed to be insolvent when it does or fails to do certain things prescribed by law. Most commonly a company is deemed insolvent if it fails to satisfy a creditor's statutory demand.

CAN SOLVENT COMPANIES BE WOUND UP?

Yes. Solvent companies can be wound up by its members via a members' voluntary winding up.

Solvent companies can also be wound up by the court by way of an application to the court by its directors or members. Court appointments are common when there is a conflict with the control or conduct of the company and its members are unable to reach a resolution, or cannot agree to appoint a liquidator voluntarily.

WHAT IS PROVISIONAL LIQUIDATION?

The court may appoint a liquidator provisionally to exercise interim control over the assets and affairs of a company. The appointment is usually for the period between filing the winding up application, and the court hearing. A provisional liquidator appointment is made when the court believes that assets may be at risk and should be protected in the interest of creditors until the winding up hearing. The appointment is 'provisional' as the company may not be wound up at the application hearing, at which time control may pass back to its directors.

WHO ADMINISTERS A LIQUIDATION?

Liquidations can only be administered by specialist accountants who are registered liquidators with ASIC. They can take all types of corporate insolvency appointments, including those ordered by the courts.

WHAT POWERS DO LIQUIDATORS HAVE?

The Corporations Act sets out the liquidator's powers. These powers include all the powers vested in the directors of the company, plus the powers to:

- investigate and examine the affairs of a company
- identify transactions that are considered void
- examine the directors and others under oath (public examination)
- realise the assets
- conduct and sell any business of the company
- admit debts and pay dividends.

WHAT DOES THE LIQUIDATOR DO?

The liquidator will:

- identify and protect the assets of a company
- realise those assets
- conduct investigations into the financial affairs of a company and any suspicious transactions
- make appropriate recoveries
- issue reports to ASIC and creditors
- make a distribution to creditors
- make a distribution to shareholders (if a surplus exists)
- apply to ASIC to deregister a company.

WHAT IS THE EFFECT OF LIQUIDATION ON A COMPANY?

When a company is liquidated, its structure survives the appointment of a liquidator, but not the liquidation. Control of assets, conducting business, and other financial affairs are transferred to the liquidator. The directors cease to have any authority. All bank accounts are frozen, any employment can be terminated, but necessary labour may be engaged by the liquidator. At the end of the liquidation, the liquidator applies to ASIC for the company to be deregistered, after which the company will cease to exist.

Liquidation

CAN A COMPANY TRADE WHILE IN LIQUIDATION?

A liquidator may continue trading a company if it is in the creditors' best interest. A trade-on is considered if there is a prospect to sell the business as a going concern, or to complete and sell any work-in-progress. A liquidator is obligated to end trading and wind up company affairs as quickly but as commercially responsible as practical.

WHAT MUST THE DIRECTORS DO TO HELP THE LIQUIDATOR?

The directors must give all information about the company's financial affairs and provide a Report as to Affairs (detailing the assets and liabilities of the company as at the date of appointment of the liquidator) and assist the liquidator when reasonably asked. The directors must also deliver all company books and records and cooperate with the liquidator throughout the liquidation process. The Corporations Act contains various offence provisions that apply to directors who do not cooperate with liquidators.

WHAT INVESTIGATIONS ARE UNDERTAKEN BY THE LIQUIDATOR?

The liquidator must investigate:

- why a company is insolvent
- when a company became insolvent
- a potential insolvent trading claim against the directors
- any recoverable preferential payments to creditors
- any possible offences committed by the company officers
- if any void transactions can be overturned
- if any other recoveries may be made.

These powers include holding public examinations, seizing books and records and gaining access to property. The liquidator must also identify any offences committed by the directors and report these to ASIC.

CAN THE LIQUIDATOR RECOVER PROPERTY SOLD BEFORE THE LIQUIDATION?

The liquidator will look at any sales, or transfers of property within the years before liquidation. If property transactions appear improper, uncommercial or undertaken to defraud creditors, that property or its value may be recoverable. The liquidator can recover money from creditors who received payments that gave them 'preferential' treatment in the six months before the liquidation.

WHAT IS INSOLVENT TRADING?

Directors have a duty to ensure that their company does not continue to incur debts when it is insolvent. If the director breaches that duty, the liquidator can bring an action against them for recovery of the amount of the debts incurred during the period that the company was insolvent. The insolvent trading claim is made against the directors personally, making them personally liable to compensate the company for the unpaid debts.

MORE INFO:
INSOLVENT TRADING P48

CAN A LIQUIDATOR ATTACK A DIRECTOR'S PERSONAL ASSETS?

No. A liquidator can only take possession of a company's assets. However, if a liquidator can prove that the directors have taken company assets, the liquidator may then recover those assets. If a company has loaned money to the directors, the liquidator will seek to recover the money, and if necessary may instigate legal proceedings to recover these funds.

If a liquidator can establish an insolvent trading claim, they may take recovery action against any directors and, if necessary, commence bankruptcy proceedings against that director. This allows a bankruptcy trustee to access the director's assets to satisfy the liquidator's claim.

HOW DO PERSONAL GUARANTEES BECOME PART OF THE LIQUIDATION?

When directors, or other parties, execute a personal guarantee, it becomes a personal arrangement between creditor and guarantor, and therefore not affected by liquidation.

MORE INFO:
DIRECTOR'S LIABILITIES P36

WHAT EFFECT DOES THE LIQUIDATION HAVE ON SECURED CREDITORS?

Secured creditor's rights are not affected by liquidation. Commonly, secured creditors allow liquidators to sell the assets while recognising the secured creditor's rights. A secured creditor can prove for any shortfall in the liquidation after their security is realised.

WHAT IS THE EFFECT OF THE LIQUIDATION ON UNSECURED CREDITORS?

Unsecured creditors lose their right to recover money from the company, but gain a right to prove for dividends in the liquidation.

CAN A LIQUIDATOR PAY DIVIDENDS?

Yes. The ultimate role of the liquidator is to realise the company's assets and take all possible steps to recover sufficient funds to distribute the proceeds among creditors.

ARE THE DIVIDENDS PAID UNDER CERTAIN PRIORITIES?

Yes. The liquidator must pay dividends in the order of priorities set out in section 556 of the Corporations Act.

These priorities include:

1. costs and expenses of the liquidation
2. costs of the applicant creditor (if the company was wound up by the court)
3. employee entitlements
4. other unsecured creditors.

MORE INFO:
DIVIDENDS P83

HOW LONG DOES THE LIQUIDATION LAST?

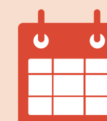
There is no set time limit for a liquidation. The liquidation lasts for as long as necessary to complete all the required tasks of liquidation; however, a liquidator will usually try to finalise the liquidation as soon as possible.

HOW DOES THE LIQUIDATION END?

The liquidation ends when:

- the company is dissolved by a court order on the application of the liquidator, or
- the company is struck off the register of companies by ASIC at the request of the liquidator, or
- the winding up is set aside or stayed by the court.

MORE INFO:
ENDING A LIQUIDATION P32



THRESHOLDS

A statutory notice can be issued for a minimum of $2,000 and the debtor has 21 days to pay or be deemed insolvent.

Holding other liquidation meetings: At any time during appointment with 10 business days' notice.

1st creditors meeting within 18 days of appointment (11-day convening + 7-day notice).

No set period for a liquidation's term.

Voluntary Administration

CASE STUDY

Football Club calls half time with a voluntary administrator

Worrells passes the ball back to the Board.

In this case, Worrells was appointed in time to avoid a business closure and liquidation. This case study highlights that if proactive action is taken before a business's financial position becomes inevitable, business survival is possible—no matter how bleak the financial position may appear at first glance. Our early appointment in this matter meant that there was sufficient time and working capital to enable a restructure. The ultimate result was a far better outcome for the creditors, employees, and the community.

Background

The Frankston Football Club (FFC) had a history dating back well over 100 years. The FFC not only had the 'Frankston Dolphins' competing in the Victorian Football League (VFL) but its facilities were also used as a key meeting centre for the local community.

FFC was run through an incorporated association structure and its Board of Management comprised of volunteers, which were elected by the club's members. The nature of the voluntary board position meant that there were frequent changes to the board's composition; particularly in the few years prior to our appointment. Over time, it appears that the club's focus fell away from revenue generation and cost cutting—complacency had set in.

In the few years prior to our appointment the club had begun suffering trading losses. Those losses intensified because game patronage and membership reduced, due in part to poor on-field performance by the club's football team.

To try to curtail the financial issues, it was decided to revamp the club's facilities—funded largely by the landlord (the Frankston City Council). While the updated facilities expected to generate more revenue in the years to come, the construction works severely interrupted the club's usual operations throughout 2015. This further impacted on sales and patronage, which compounded the already overwhelming financial pressure.

The poor financial position was well-known and often discussed by the board and FFC members, but none of the difficult decisions had been made. During January 2016 however, the majority of the board was replaced with new members prepared to proactively contribute to club operations. The new members' initial enquiries raised a number of alarm bells. In particular, the board found the club's poker machines were in fact losing some $1,600 per week—far from the revenue generator they were expected to be. In April 2016, it was decided to relinquish the club's rights to the poker machine licences. Other initiatives were also implemented but it became abundantly clear: the financial position was far worse than anticipated.

By August 2016 the FFC had due and payable liabilities of:

Poker machine-related debts:	$732,000
Landlord:	$68,000
Player and employee entitlements:	$240,000
Other liabilities:	$250,000
Total	$1,290,000

If the club were to close however, its liabilities would substantially increase due to, among other things, crystallised employee redundancies and leave pay-outs. In addition, the club had committed to paying $10,000 per month, until 2020 (three and half years) in a kitchen fit-out lease. If the club was to cease trading, that full lease liability of some $420,000 would also crystallise.

On the assets side, the club's only real assets were:

Cash at bank:	$90,000
Debtors:	$90,000
Plant and Equipment:	$20,000 (realisable value)
Total	$200,000

Trading position

Importantly, while the liabilities well outstripped the assets, the day-to-day trading position was far more positive. Forecast budgets projected that the club's cash-inflows were likely to well exceed its cash-outflows. And there was also plenty of room for improvement if the club had a clearer focus on generating revenue and decreasing its costs. The business fundamentals appeared to be there—the issue however, was the club's inability to service its poker machine debts.

Options available

When we met with the board, the club had received a formal demand from the Minister of Consumer Affairs, Gaming and Liquor Regulation for a part of the poker machine-related debt (some $475,000). The club had a short window in which it needed to either repay, or come to an arrangement on that debt. The board could not see how the club could deal with that liability given its magnitude.

The board sought our advice on the options available, which included:

1. Ceasing trade

This would mean entering into liquidation, the club's closure and selling its assets—and unfortunately, the end of an era for the community. More importantly, upon our assessment, the asset sale proceeds would be insufficient to pay employee/player liabilities let alone any other creditors' debts.

2. Do nothing

Eventually, a creditor would apply to wind up the club to recover its debt and this action (or inaction) would result in liquidation (i.e. option 1). We also explained to the board their personal exposure if they allowed the club to continue to trade-on in the current circumstances (i.e. trade while insolvent).

3. Appoint a voluntary administrator with the aim to propose a Deed of Arrangement (DOA) (similar to a Deed of Company Arrangement for companies) to continue to trade.

As voluntary administrators, we would take control of the management and operations of the club. If satisfied the club had a future and a DOA was deemed viable, the administrators (in conjunction with the board) could present a DOA proposal to creditors for approval. If accepted, control of the club would pass back to its board.

In August 2016, the board decided on option 3 to appoint us as administrators. This was a difficult decision for the board but one with the club's best interests in mind.

Administrators' role and actions

Our role as the appointed administrators included:

Ascertaining asset values and verifying any asset securities;

Supervising and managing the club's trading; and

Forecasting and assessing its future trading and profitably to determine its prospects of restructure.

Above all, to gauge and gain support for the club's survival, we consulted with the football players, employees, creditors, club sponsors, the Australian Football League (AFL), the local council, members of parliament, and the local community. Given the strong support from stakeholders, we promptly determined a restructure of the club may well be feasible.

As a result, trading of the business continued during the voluntary administration period. Naturally, certain controls to minimise trading expenses were strictly implemented—for example, reducing bar operating hours and enforcing strict profit margins for future event functions.

Assets and Securities

Reviewing the validity of securities over assets is a complex area and requires consideration of the provisions of the *Personal Property Securities Act 2009* (PPSA). If a party provided goods to the club without a registered security interest on the Personal Property Securities Register (PPSR), or it was incorrectly registered, then in most situations—there is no security and the party who supplied the asset/property would become an unsecured creditor.

Our investigation identified:

- The security interest registered over the kitchen fit-out was defective ($420,000 claimed). This financer had inadvertently registered their interest as a "transitional security interest" (i.e. they ticked the wrong box on the PPSR form). Although this did not become a live issue in the administration, it potentially rendered the security interest defective. This example illustrates how careful creditors must be when registering securities on the PPSR.
- The lessee of several coffee machines (and associated equipment) used by the club did not register a security interest on the PPSR, with the creditor advising that they had never even heard of the PPSA. Without a valid registration, the result was again a demotion of the creditor's rights to that of an unsecured creditor.

The board's efforts

The club was fortunate to have a board prepared to work with us to restore the club's profitability. The board members proactively approached members of parliament seeking support, and enlisted the local media to engage and make the public aware of the club's plight. The board also assisted to gain support from Frankston City Council and other key creditors through a restructure. While the AFL independently resolved not to allow the Frankston Dolphins to compete in the 2017 VFL season, the board engaged with AFL representatives to determine what was required to ensure a licence would be granted in 2018, if the club could continue through a restructure.

Proposed restructure

After lengthy consultation with our office and key stakeholders, the board proposed a DOA on the following broad terms:

The club would be given a clean slate in that all existing creditors would be locked-down and unable to pursue the club for their debt (i.e. their rights would be limited to a claim in the administration).

We, as administrators, would retain cash at bank and debtors, but the plant and equipment—which was integral to future trade—would revert to the club.

Of the funds collected, the administrators would provide the club with sufficient working capital to see through its initial trading period.

Over a five-year period, the club would make contributions to the administrators totalling more than $400,000. The administrators would use contributions, and all other administration recoveries, to discharge the club's quarantined liabilities.

The club would appoint a new and experienced board and implement a raft of changes to increase profitability and re-focus the club on its finances.

The club would report their management accounts each quarter to the administrators over the five-year period to ensure club operations continue profitably.

If the club were to be placed into liquidation, the players and employees would receive, at best, a partial return on their entitlements, and ordinary unsecured creditors would have a zero return. Under the DOA it was expected that all player and employee entitlements would be paid in full and unsecured creditors would have a material return as well.

As a result, we recommended that creditors accept the proposal.

Creditors vote

The creditors voted overwhelmingly in favour of the DOA. Shortly after the vote we signed a formal agreement and passed control back to the board and management team. The DOA was formalised in mid-November 2016, some three months after our appointment.

Outcome

In the few months following the DOA being implemented, the FFC is trading positively and is no longer shackled by its historical debts. A raft of changes have, and continue to be implemented, to ensure the club's financial position is viable into the future. Several key and experienced personnel have also been appointed to the board to oversee the club's operations.

While creditor's debts have been quarantined and they will need to wait for payment, those parties will receive a materially greater return if the DOA is successful than would have been the case if the club had simply ceased trade—or been liquidated.

This administration case study illustrates how working with insolvency practitioners can assist a failing business to return to profitability, particularly when management actively embraces change. It also shows the urgency to act early as there are significantly more options to turnaround or restructure a business.

What is voluntary administration?

The voluntary administration process is designed to assist insolvent companies satisfy their debts, by ensuring that they can either:

1. come to a formal arrangement with their creditors to pay those debts through a Deed of Company Arrangement (DOCA), or
2. be placed into liquidation, quickly and inexpensively.

The voluntary administration process maximises the chances of a company continuing to exist by giving it the opportunity to propose a DOCA to its creditors.

WHY CHOOSE VOLUNTARY ADMINISTRATION?

A voluntary administration offers a collaborative approach to satisfying the company's debts. It restrains creditors from enforcing their claims, and can assist a company to trade out of short-term difficulties caused by cash-flow restrictions or one-off financial problems. When appropriate, it can also provide a way to restructure a business or the company itself to revive it to a healthier financial position.

HOW DOES A VOLUNTARY ADMINISTRATION BEGIN?

A voluntary administration begins when an appointment document is executed by either:

- the directors of a company after they have resolved that the company is, or is about to, become insolvent
- a liquidator if a proposed DOCA will provide a better return to creditors than the continued liquidation
- a secured creditor after the terms of their finance agreement has been breached and the administrator consents to the appointment.

WHAT IS THE VOLUNTARY ADMINISTRATION PROCESS?

A voluntary administrator is appointed to control a company's affairs. The administrator convenes two meetings of creditors. The first meeting is held within eight business days of the appointment. The second meeting is usually held within 20 to 30 business days after the appointment. At the second meeting, creditors will choose the option they believe will best serve their interests.

The two most common outcomes of a voluntary administration are the execution of a DOCA or the liquidation of the company.

WHAT IS THE EFFECT ON SECURED CREDITORS?

Secured creditors have 13 business days from the appointment date to exercise their security. If they do not do so within that time, they are bound by a moratorium for the duration of the voluntary administration period. This decision period gives the secured creditor time to decide whether to exercise their charge, and the administrator some certainty during the administration.

Creditors decide the future of the company at the second meeting.

WHAT IS THE EFFECT ON UNSECURED CREDITORS?

A moratorium is imposed on unsecured creditor actions—they cannot enforce their claims or apply to wind up a company.

A provisional liquidator cannot be appointed to a company without the leave of the court, and all proceedings or enforcement action against a company's property is placed on hold.

WHAT ARE THE ADMINISTRATOR'S POWERS?

The administrator assumes control of a company's business, property and financial affairs. The administrator assumes sole responsibility to perform all functions and exercise any and all director powers that could be exercised if the company was not under administration, including continuing to trade or dispose of all or any part of a business or property. The directors and other officers lose all these powers.

WHAT DOES THE ADMINISTRATOR DO?

The voluntary administrator will:

- take control of the company's assets
- investigate the company's affairs
- report any offences to Australian Securities and Investments Commission (ASIC)
- assist the directors to formulate a DOCA proposal
- report to creditors on the course of action that gives for the best outcome for creditors
- call the required meetings of creditors to decide the future of the company.

DOES THE ADMINISTRATOR LOOK AT PREFERENCES?

The administrator is required to investigate potential voidable transactions, but only to carry out sufficient investigations to justify any recommendations made in the report to creditors. The administrator has no power to commence any recovery proceedings.

MORE INFO:
PREFERENCES IN LIQUIDATIONS P44

PERSONAL PROPERTY SECURITIES ACT 2009 AND VOLUNTARY ADMINISTRATORS

In the event of the appointment of a voluntary administrator to the company under Part 5.3A, section 440B of the *Corporations Act 2001* imposes restrictions on:

- an owner of property used by the company from taking possession of or recovering the property
- a lessor from levying distress rent, taking possession, or otherwise recovering the property
- a secured party with possessory security from selling the property or otherwise enforcing the security interest.

The voluntary administrator may still sell or dispose of assets:

- with the consent of the secured party
- with the consent of the court
- in the ordinary course of business.

Any disposal made by the voluntary administrator requires the sale proceeds from the secured property to be distributed to those holding relevant security interests.

HOW DOES THE VOLUNTARY ADMINISTRATION AFFECT A LANDLORD?

A landlord is bound by the same moratorium applying to all creditors, providing the landlord did not commence enforcement proceedings prior to the appointment.

The administrator can occupy the company's leased premises for up to seven calendar days without paying rent, but must pay rent for the remainder of the voluntary administration period.

The administrator's liability to the landlord ends at the conclusion of the voluntary administration or when the premises are vacated. The administrator will not be liable for rent if they do not have possession of the property. However, the company will continue to incur liability for the rent.

HOW DOES A VOLUNTARY ADMINISTRATION AFFECT GUARANTEES?

Creditors holding third-party guarantees from directors are bound by the moratorium during the period of the administration. After the voluntary administration ends, guarantees can then be enforced.

MORE INFO:
DIRECTOR'S LIABILITIES P36

Voluntary Administration

CAN A VOLUNTARY ADMINISTRATOR PAY DIVIDENDS?

No. A voluntary administrator does not have the authority to pay dividends.

WHAT HAPPENS AT THE FIRST MEETING OF CREDITORS?

The first meeting of creditors is held within eight business days after the appointment of the voluntary administrator. The Corporations Act requires two matters to be considered at this meeting:

1. if creditors wish to replace the administrator with another administrator
2. if creditors wish to elect a number of representatives to form a committee that will advise and assist the administrator.

WHAT HAPPENS AT THE SECOND MEETING OF CREDITORS?

A second meeting of creditors is normally held between 20 to 30 business days after the appointment. Creditors will decide the future of the company at this meeting. Before this meeting the administrator will issue a report detailing the results of investigations, offences (if applicable) and the viability and suitability of each option available to creditors.

The report must include sufficient information for creditors to make an informed decision in respect of the future of the company, and provide a recommendation to creditors.

WHAT OPTIONS ARE AVAILABLE TO CREDITORS?

The creditors can pass a resolution to:

1. accept a proposal for a DOCA (if one is proposed)
2. end the voluntary administration and pass control of the company back to the directors
3. liquidate the company.

MORE INFO:
DOCA P26

HOW COMPLETE MUST A DRAFT DEED OF COMPANY ARRANGEMENT BE?

Commonly a draft DOCA is submitted to the administrator in summary form. A full draft DOCA is preferred to be tabled at the meeting of creditors, as the final DOCA will include many technical provisions.

Creditors should insist on the full draft, or at least as close to the final draft as practicable, so they are fully aware of all of the terms. The meeting can be adjourned to allow time to produce a more detailed draft.

THRESHOLDS

- 1st creditors meeting is held 8 business days after appointment
- 2nd meeting is held 20-30 business days after appointment
- Secured creditors have 13 business days after appointment to exercise their security.
- A moratorium can apply to the company's leased premises for up to 7 calendar days without paying rent. Other terms apply.
- No personal guarantees can be exercised in this appointment.
- No set period for a voluntary administration's term.

VOTING AT MEETINGS

A vote can be determined ‘on the voices’ if there is a clear majority of those present at a meeting. Each person (whether a creditor or a proxy) only has one vote.

If the vote is inconclusive, or if requested by creditors, the vote can be put to a poll. A poll works on a majority in both numbers and values. In the event of a stalemate (i.e. majority of numbers voting one way and the majority of value voting another), the administrator will generally exercise a casting vote and make the final decision. Otherwise the resolution will fail.

DO CREDITORS NEED TO DECIDE ON A COURSE OF ACTION AT THE SECOND MEETING?

No. The second meeting may be adjourned for up to 45 business days for further investigations to be carried out, or for a proposed DOCA to be amended. The court has the power to extend this period if there is a genuine reason for an extension.

WHAT DOES A VOLUNTARY ADMINISTRATION COST?

Each administration is different and will therefore have a different cost depending on the work required. There are two types of work on insolvency files, statutory and non-statutory, but both are necessary.

Statutory work is required on every file regardless of size, complexity or other unique factors. Statutory work includes:

- notifying ASIC
- issuing notices to creditors
- issuing notices to utilities and statutory authorities, such as the Australian Taxation Office
- conducting the first meeting of creditors
- dealing with creditors’ enquiries
- conducting preliminary investigations into preferential payments, insolvent trading and other voidable transactions
- preparing and issuing a detailed report to creditors
- conducting the second meeting of creditors
- notifying creditors and ASIC of the outcome of the second meeting of creditors.

Non-statutory but still necessary work may include the following tasks:

- trading on the business
- dealing with secured creditors
- dealing with finance companies
- collecting and selling some or all of a company’s assets or the business of a company
- more detailed investigations into potential recoveries, assets ownership and the viability of any proposal for a DOCA.

WHEN DOES A VOLUNTARY ADMINISTRATION END?

The voluntary administration ends when:

- a DOCA is fully executed
- the creditors resolve to wind up a company
- the creditors resolve that the voluntary administration should end
- the court orders that the administration is to end
- the approved DOCA is not signed within 15 business days of the second meeting
- the period for calling the second meeting ends without the meeting being called
- the court appoints a liquidator to the company.

HOW SHOULD A COMPANY UNDER VOLUNTARY ADMINISTRATION BE REFERRED TO?

While in voluntary administration, a company must advertise its status. For example, ABC Pty Ltd should be described as ABC Pty Ltd (administrator appointed) on all public documents.

Deeds of Company Arrangement

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Business survival impossible without the support of critical stakeholders

20 to 40 cents in the dollar, versus nil.

A local business appointed Worrells as voluntary administrator so the director could put forward a Deed of Company Arrangement (DOCA) proposal to creditors. We discussed the proposal and it was going to be a reasonable proposal with a large up front lump sum payment and then payments from profits over time.

To facilitate the option for a DOCA, it was vital that the company continue to trade during the voluntary administration period. That being the case, we held immediate discussions with the bank who held security over all the assets, the landlord, and the critical suppliers to the business. The possibility of a DOCA proposal was explained and they all agreed that they would continue to provide support during the voluntary administration period. We then continued to trade on the business with all focus on finalising the details of the DOCA proposal for creditors. The return under the DOCA proposal was looking like being anywhere from 20 to 40 cents in the dollar versus the return under a liquidation scenario which was likely to be nil.

Only a matter of days later the landlord issued a notice to vacate the premises. Without the premises, trade and therefore the DOCA was impossible. After discussions with the landlord it became clear that while the landlord appreciated that he was potentially losing any chance of recovering funds by evicting the company, and removing any possibility of a DOCA being put forward, he made it very clear that he did not want the tenant for the long term. He was of the view that the company had been breaking numerous obligations and quite frankly didn't want to deal with the company any longer.

This sudden turn of events meant that a DOCA proposal was not possible. The company immediately ceased to trade and vacated the premises. The company was subsequently placed into liquidation and there was no return to creditors. Had the company taken more care in preserving its relationship with the landlord, the outcome may have been very different.

The message is clear that businesses need to ensure that they do all they possibly can to maintain positive relationships with key stakeholders in the business. The absolute critical stakeholders that need to be kept onside are:

1. The financing bank
2. The landlord
3. Critical suppliers.

Without the support of the above stakeholders, survival in the business world is going to be very difficult, even impossible.

What is a Deed of Company Arrangement?

A Deed of Company Arrangement (DOCA) is a formal agreement between a company and its creditors and any other relevant third parties to satisfy company debts. A DOCA sets out terms and conditions, warranties and indemnities, the extent and nature of obligations, and the relationships between those who are a party to it.

A DOCA binds all creditors, both unsecured and secured, to the extent of any shortfalls on their securities and releases the company from its debts, at least to the extent provided for within the DOCA's terms and conditions.

WHY CHOOSE A DOCA?

A DOCA aims to maximise the chances for a company to continue to exist, or to continue one aspect of its business. Alternatively, a DOCA will provide a better return for creditors than an immediate winding up of a company.

WHO CAN PROPOSE A DOCA?

A DOCA proposal is usually put forward by company directors. However, it is not limited to only directors; any third party may propose a DOCA.

WHAT HAPPENS IF THE DOCA IS NOT EXECUTED?

When creditors vote for a DOCA, the company must sign the DOCA within 15 business days of the creditors' meeting, unless the court allows a longer time. If this deadline is not met, the company will automatically go into liquidation, and the voluntary administrator becomes the liquidator.

HOW LONG DOES A DOCA LAST?

A DOCA lasts for as long as is provided for in its terms, and until all deed obligations are satisfied. The DOCA must state its term and its moratorium period. If the DOCA does not specify an end date, or ending conditions, it is invalid.

ARE SECURED CREDITORS BOUND BY THE DOCA?

A secured creditor is only bound by a DOCA if they are a party to the deed, or agree to be bound by it. The court can order to limit the rights of a secured creditor, but this situation is not common. If a secured creditor suffers a shortfall, that debt then falls within the provisions of the DOCA.

TIMING

Approved DOCA must be signed within 15 business days of creditors meeting.

No set period for a DOCA's term.

HOW DOES A DOCA AFFECT DIRECTORS' GUARANTEES?

Creditors holding guarantees from directors or other parties are bound by the moratorium during the voluntary administration period. Guarantees are enforceable once a DOCA is signed, or the company is wound up. The release of the company's debt under the terms of the DOCA does not discharge a guarantor's liability for any shortfall.

MORE INFO: DIRECTOR'S LIABILITIES P36

CAN CREDITORS VARY THE DOCA AFTER IT HAS BEEN EXECUTED?

Yes. Creditors can vary or terminate a DOCA by resolution at a creditors meeting. The administrator must convene the meeting at the request of at least 10 percent of the value of all creditors. Alternatively, the administrator may convene a creditors' meeting if it is deemed beneficial. Any amendment to the DOCA terms must have the company's consent. Creditors can apply to the court for the DOCA to be varied or terminated.

WHAT HAPPENS TO TAX LOSSES?

A company proposing a DOCA is likely to have tax losses. These losses are usually preserved; however, they may be lost or reduced if a company fails to pay its creditors 100 cents in the dollar. Directors should seek tax advice before proposing a DOCA to contemplate tax losses being available at the end of the DOCA.

CAN A DEED ADMINISTRATOR PAY DIVIDENDS?

Yes. A deed administrator's role is to pay a dividend to creditors.

MORE INFO: DIVIDENDS P83

WHEN DOES A DOCA END?

The DOCA ends when its terms are satisfied, or when a creditor applies to the court to terminate, and is subsequently granted.

WHAT HAPPENS IF THE COMPANY DOES NOT COMPLY WITH THE DOCA?

If the DOCA terms are not satisfied, it is considered to be in default. Usually, a default notice will be issued by the deed administrator. If the default is not rectified within the period set out in the notice, the agreement will be breached. The DOCA may contain enforcement provisions or the deed administrator may have access to guarantees given in support of the DOCA. The DOCA may also be terminated by:

- the provisions of the agreement, automatically terminating the DOCA
- passing a resolution at a creditors' meeting
- an application to court and the subsequent granting of an order.

A DOCA termination usually results in the company being placed into liquidation.

HOW SHOULD A COMPANY UNDER A DOCA BE REFERRED TO?

While subject to a DOCA, a company must advertise this status. For example, ABC Pty Ltd should be described as ABC Pty Ltd (Subject to Deed of Company Arrangement) on all public documents.

Statistics collated from the 2015-16 year showed:

24% of company insolvency administrations had potential for successful trade through an accepted DOCA (i.e. to turnaround from insolvent state to a solvent state).

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Members' Voluntary Winding Up

What is a Members' Voluntary Winding up?

A members' voluntary winding up is the process for a solvent company when its members no longer wish to retain the company's structure because the company has reached the end of its useful life.

WHY CHOOSE A MEMBERS' VOLUNTARY WINDING UP?

A members' voluntary winding up is the only way to fully wind up the affairs of a solvent company. All outstanding creditors are paid in full, and any surplus assets are distributed to its members. A members' voluntary winding up also protects the members' interests while the company structure is dismantled.

WHEN IS A COMPANY SOLVENT?

Usually a company is only considered solvent if it can pay all of its debts as and when they fall due. However, this strict definition does not apply to members' voluntary winding up as the appointment lasts for 12 months. If a liquidator forms the view that all creditors will not be paid in full within the 12-month period, the members' voluntary winding up must convert to a creditors' voluntary winding up administration.

HOW IS THE MEMBERS' VOLUNTARY WINDING UP PROCESS STARTED?

The directors resolve to call a meeting of members to wind up the company. Directors must complete a 'declaration of solvency' that states the company is solvent and can pay all its debts within 12 months. The declaration is lodged with the Australian Securities and Investments Commission (ASIC) before the members' meeting. The solvent company is then wound up on the resolution of its members at the meeting.

WHAT IS THE EFFECT ON THE COMPANY?

The company structure itself survives the appointment of a liquidator. The control of all assets, conducting any business, and financial affairs are transferred to the liquidator. The directors cease to have any authority. All bank accounts are frozen, any employment can be terminated and the liquidator may engage necessary labour. At the end of the liquidation, the liquidator applies to ASIC to deregister the company, after which the company ceases to exist.

CAN A COMPANY TRADE WHILE IN LIQUIDATION?

A liquidator may continue trading a company if it is in the creditors' best interest. A trade-on is considered if there is a prospect to sell the business as a going concern, or to complete and sell any work-in-progress. A liquidator is obligated to end trading and wind up company affairs as quickly but as commercially responsible as practical.

WHAT MUST THE DIRECTORS DO TO HELP THE LIQUIDATOR?

Directors must supply the liquidator with all information about the company's financial affairs and provide a Report as to Affairs (detailing the assets and liabilities of the company as at the date of appointment of the liquidator) and a director's questionnaire. Directors must deliver all company books and records, and cooperate with the liquidator throughout the liquidation. Various offence provisions relate to directors that do not cooperate with liquidators.

THE INVESTIGATION PROCESS

Many of the investigations normally conducted under a creditors voluntary or court liquidation are not required under a members' voluntary winding up. As the company is solvent and creditors should be paid in full, there is no need for any recovery actions to be initiated. Preferential payments and insolvent trading are recovery actions that require the company to be insolvent at the time of the transaction, or if there is a loss to creditors.

Liquidators may have to verify what assets are available to them. Commonly, some assets are loans made to shareholders and are sometimes either in dispute or insufficiently recorded. In these cases, the liquidator has to reconstruct the loan accounts to determine the amounts and extent of the debts.

A liquidator must ensure a proper distribution is made to members through the capital accounts of the company. This distribution requires some investigation into a company's balance sheet, particularly capital reserve accounts and franking accounts. Generally, the company's external accountant can provide a current and detailed balance sheet showing all equity accounts. The liquidator then pays the distribution to members in the most tax-advantageous way.

HOW LONG DOES THE MEMBERS' VOLUNTARY LIQUIDATION PROCESS LAST?

The members' voluntary liquidation lasts for as long as necessary. Selling assets and paying creditors usually happens within the first few months. Completing the company's financial statements and final tax returns could potentially delay the distribution to members, particularly if there is a dispute between members. Clearance from the Australian Taxation Office (ATO) is essential before a members' voluntary liquidation can be finalised.

CAN A LIQUIDATOR PAY DIVIDENDS?

Yes. The role of the liquidator is to sell the company's assets and distribute them among:

1. company creditors as a dividend, and then
2. company shareholders as a distribution.

ARE THE DIVIDENDS PAID UNDER CERTAIN PRIORITIES?

Yes. The liquidator must pay dividends under a set of priorities. These priorities include:

1. the costs and expenses of the liquidation
2. employee entitlements
3. non-priority creditors
4. members.

While the liquidator follows these priorities, all creditors should be paid in full within the first 12 months.

HOW DOES THE PROCESS END?

The members' voluntary liquidation process ends when the liquidator calls a final meeting of the company's members. The meeting will only be called after all creditors' claims are satisfied, all other issues are resolved, and any surplus is distributed to the members. This meeting is a statutory process and attendance by members is optional.

The company is automatically deregistered by ASIC three months after the final meeting is held.

TIMING

12-month limitation on a members' voluntary winding up.

ASIC automatically deregisters a company 3 months after final creditors meeting.

Ending a Liquidation

How can a company get out of liquidation?

A liquidation usually ends with a company being deregistered. However, there are two other ways a liquidation could end:

1. the liquidator appoints a voluntary administrator to a company, which leads to a Deed of Company Arrangement (DOCA)
2. the court orders the stay or termination of a winding up.

WHEN WILL A LIQUIDATOR APPOINT A VOLUNTARY ADMINISTRATOR?

Liquidators appoint a voluntary administrator to a company when they believe creditors will receive a greater return under a proposed DOCA, than under a liquidation. The liquidator must be convinced that the DOCA proposed is worthwhile and is likely to be accepted. When the DOCA is accepted and signed, the liquidator applies to the court to end the liquidation.

WHEN DOES THE COURT END A LIQUIDATION?

Generally, an application to court for an order staying or terminating the winding up of a company happens shortly after the initial winding up was ordered, but is not essential. Technically, an application can be made at any time, but it becomes less viable the longer the liquidation continues.

WHICH COURT CAN MAKE A STAY ORDER?

The power to wind up companies resides with the Federal Court of Australia, the Supreme Court in each state and the Family Court of Australia. These courts have jurisdiction to order the stay or termination of a winding up. In most cases, a stay application is made in the court that ordered the original winding up. However, a stay application can be made to any of these courts, and they can subsequently transfer applications between the courts.

WHO CAN APPLY FOR STAY ORDERS?

Under section 471A of the *Corporations Act 2001*, director's powers are removed while the company is in liquidation. The residual powers of the directors only allow them to resist or appeal against the original winding-up application or order.

Usually, the liquidator will make a stay application after a DOCA is signed, or a contributory or company member can make an application to stay or terminate the winding up.

WHY WOULD THE COURT MAKE AN ORDER TO END A LIQUIDATION?

A court can make an order to end a liquidation for many reasons, including:

- The winding-up application and other supplementary material was not served on the company in the proper way or in a way that did not allow the company to suitably defend it. That is, the process of winding up the company was deficient.
- The company is solvent and should not have been wound up.
- The liquidator has appointed a voluntary administrator and this appointment resulted in the company entering into a DOCA. The liquidation is no longer necessary.
- It is just and equitable to do so for any other reason.

WHAT FACTORS ARE CONSIDERED BY THE COURT TO END A LIQUIDATION?

A New South Wales Supreme Court decision in 2002 provides some insight into what the courts may look for when considering an application to end a liquidation. In this case, the judge listed eight criteria:

1. The granting of a stay is a discretionary matter, and there is a clear onus on the applicant to make out a positive case for a stay.
2. There must be service of a notice of the application for a stay on all creditors and contributories, and proof of this.
3. The nature and extent of the creditors must be shown, and whether or not all debts have been or will be discharged.
4. The attitude of creditors, contributories and the liquidator is a relevant consideration.
5. The current trading position and general solvency of the company should be demonstrated. Solvency is of significance when a stay of proceedings in the winding up is sought.
6. If there has been non-compliance by directors with their statutory duties as to the giving of information or furnishing a report as to affairs, a full explanation of the reasons and circumstances should be given.
7. The general background and circumstances which led to the winding up order should be explained.
8. The nature of the business carried on by the company should be demonstrated, and whether or not the conduct of the company was in any way contrary to 'commercial morality' or the 'public interest'.

WHAT HAPPENS TO THE COMPANY AFTER THE WINDING UP IS STAYED?

The company directors usually take control of company affairs as soon as the order is given to stay the winding up. Some circumstances make this inappropriate, particularly if the company was wound up due to disputes between directors and shareholders. Where there is some disagreement between the directors and shareholders, the court may make directions on the matter.

TIMING

No set period for a liquidation's term.

RECOVERIES

Director's Liabilities for Company Debts 36
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Director's Liabilities for Company Debts

Liquidation

—the ugly side for directors

If it sounds too good to be true: it really is!

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All too often we hear stories of directors not properly advised of what happens in a liquidation scenario. It is imperative that when companies are facing financial challenges, the directors seek proper advice to fully understand the potential ramifications against them. If severe enough, it will lead to the likely bankruptcy of the directors. We often hear the line 'had I'd known that—I would have looked at different options', but typically the advice offered by uneducated, inexperienced, and potentially 'dodgy advisors' is that the liquidation will make all the problems go away. That is simply not true!

To give some educated, experienced, and qualified guidance on the effects of insolvency on directors, we list the more common issues that directors must fully contemplate before deciding to wind up their company.

Personal guarantees

This may seem like an obvious one, but it is often not properly considered.

A personal guarantee is a document signed by a director that guarantees the debt incurred by the company. This means that should the company fail to pay that debt; the creditor can rightfully seek payment directly from the director. Frequently, directors are unable to determine which creditors actually hold a personal guarantee because their paperwork is not in order. Once a company goes into liquidation, creditors holding personal guarantees will pursue the directors to pay the outstanding company debt. The creditors that will almost always have a personal guarantee include, a financing bank, a landlord, and any major suppliers.

Company secured creditors—the banks!

A bank that has provided finance to a company will almost always have a personal guarantee along with a mortgage over any real property the directors own, as additional security. When the company is unable to pay its debt to the bank and insufficient funds in a liquidation, the bank will call upon the guarantees and mortgages. Ultimately, if the directors don't pay the debt the bank will most likely enforce the sale of any real property offered as security with all proceeds going to the bank until their debt is satisfied in full. Most securities are held over the home, which leaves the directors homeless.

Caveats—charging clauses over property

Most personal guarantees include a 'charging' clause. It provides a 'charge' for a creditor, in the event of non-payment, to place a caveat over any real property owned by the director. This makes these creditors a 'secured creditor' over any real property owned by the director. The creditor can lodge a caveat over this real property, and if necessary, commence legal action to enforce their caveat, which may ultimately lead to a statutory trustee being appointed over the real property. The statutory trustee will sell the property and distribute the funds, firstly to the secured creditors (mortgagee and caveat holders) with the surplus funds (if any) being paid back to the property's owners. Clearly, these clauses are a very powerful tool for creditors and one that directors need to be acutely aware of.

Directors loan accounts

We are increasingly seeing director loan accounts in use. Directors seem to make the conscious decision (often after receiving advice) to only pay themselves a small salary (or even none) and simply take company funds as a directors' loan account. The advantage is that directors don't have to remit any pay as you go (PAYG) to the Australian Taxation Office (ATO). However, in a company liquidation, the first thing that the liquidator will identify is an outstanding loan account and immediately demand repayment. Often it is a significant amount outstanding and the liquidator is obligated to recover the loan account.

Insolvent trading

Liquidators have recourse over directors with insolvent trading claims. The 'Insolvent Trading' section of this Guide (page 48) details how these claims work, but ultimately, a liquidator conducts investigations to determine the point the company became insolvent and then determine the value of unpaid debt incurred after that date. This amount is what the liquidator can pursue the director to pay personally.

Director penalty notices (DPNs)

A director penalty notice (DPN) allows the ATO to seek payment of unpaid company Pay as You Go (PAYG) withholding and superannuation from a director. The 'Director Penalty Notices' section of this Guide (page 66) details how these DPNs work. Directors must be extremely mindful of DPNs, particularly if they have outstanding business activity statements (BAS) and superannuation guarantee charge (SGC) reporting obligations as they can already be automatically liable for a portion of the outstanding PAYG and superannuation. If directors are issued a DPN, immediately seeking appropriate advice on what they should do, is vital. If they 'put their head in the sand'—the problem will only get worse.

Section 588FDA actions

Section 588FDA of the *Corporations Act 2001* gives liquidators the power to pursue a director for an 'unreasonable director related' transaction. To determine whether a transaction may be considered 'unreasonable' the liquidator must establish the following:

- The payment or transfer of property was made by the company, securities were issued by the company, or the obligation was incurred by the company to make such a payment or disposition.
- The payment or disposition was made to a director, a close associate of a director or a person on behalf of the director, or close associate of the director.
- It may be expected that a reasonable person in the company's circumstances would not have entered into the transaction when regarding the benefit and detriment to the company.

This provides a liquidator with quite a wide scope to pursue company transactions and they will closely look at any transactions made to the directors' close associates (usually family).

Section 588FGA liability

This liability is almost always overlooked by directors and their advisors when considering a company winding up. If a liquidator determines the company made a 'preferential payment' to the ATO, they will take appropriate action to recover it. If the liquidator is successfully obtaining a court order for the preference payment against the ATO, section 588FGA of the Corporations Act outlines that the directors become liable to the ATO for the PAYG component of the preferential payments. So, should a liquidator recover a preference from the ATO, the ATO can make a claim against the directors for the PAYG portion of the preference.

Director banning—section 206F

Section 206F of the Corporations Act gives the Australian Securities and Investments Commission (ASIC) the power to disqualify a director for up to five years if the person is a director (or a director within the 12 months) of two or more companies that have been placed into liquidation in the previous seven years. We are seeing ASIC becoming more proactive on this front and taking more action to ban directors under section 206F.

Breaches of directors' duties

Liquidators are required to investigate into company affairs for the period prior to the liquidation. Part of these investigations include reviewing the director's actions to determine if they breached any of their director duties. The relevant sections of the Corporations Act are:

- Section 180: Care and diligence—civil obligations
- Section 181: Good Faith—civil obligations
- Section 182: Use of Position—civil obligations
- Section 183: Use of Information—civil obligations
- Section 184: Good faith, use of position and use of information—criminal offences

If a liquidator determines a breach of any of these sections, they will lodge a report with ASIC under section 533 of the Corporations Act. ASIC will review the matter and if deemed appropriate, take action to prosecute the directors.

Summary

As can be seen above, there are many forms of potential exposure for directors of a company that goes into liquidation, some of them are very serious and may have a significant adverse effect on the director. Evidently, it is imperative that directors seek proper advice from trusted advisors. The bad advisors out there are touting the message 'once the company goes into liquidation all of your problems will go away'. This is morally wrong and simply not true!

Can Directors be Liable for Company Debts?

Yes, including when directors have taken remedial action to try to solve a company's financial problems.

The areas of potential liability are:

1. insolvent trading compensation claims
2. unreasonable director-related transactions
3. loss of employee entitlement claims
4. PAYG taxation debts and superannuation contributions
5. personal guarantees.

WHAT ARE THE DIFFERENCES BETWEEN THESE LIABILITIES?

The three main differences between these areas of liability are:

1. who has the right to make a claim
2. whether or not a company must be in liquidation
3. how the liability arises.

In summary:
In liquidation, under the *Corporations Act 2001*:

- Insolvent trading claims can be made by liquidators, or creditors (section 588M and 588R respectively).
- Unreasonable director-related transactions by liquidators, under section 588FDA.
- Employee entitlement claims by liquidators, or creditors (section 596AC and 596AF respectively).

Not in external administration:

- PAYG taxation debts and superannuation claims are made by the Australian Taxation Office, under the provisions of the *Income Taxation Assessment Act 1997* (ITAA) through the director penalty notice (DPN) regime.
- Personal guarantees can be exercised by creditors holding guarantees, under their agreement document.

WHO IS A DIRECTOR?

Under section 9 of the Corporations Act directors can be appointed directors, de facto directors, shadow directors, and those acting as directors. Therefore, a person does not have to be formally appointed as a company director to be liable for claims in liquidations.

INSOLVENT TRADING

WHEN IS A DIRECTOR LIABLE FOR INSOLVENT TRADING?

Insolvent trading occurs when a company incurs a debt that it cannot and does not pay, at a time when a director knew, or should have known, that the company was insolvent. Under section 588G of the Corporations Act directors have a duty to prevent insolvent trading. The Corporations Act makes a director liable to pay an amount of compensation equal to the amount of the debt.

MORE INFO:
INSOLVENT TRADING P48

HOW MUCH CAN BE RECOVERED?

A claim can be made for compensation for losses resulting from insolvent trading. The amount claimable is equal to that of the debt incurred when the company was insolvent, as long as the debt remained unpaid at the time of liquidation.

HOW IS A DIRECTOR MADE LIABLE?

A liquidator can make a demand upon a director to compensate the liquidator for the amount of the insolvent trading claim; however, in reality, the liquidator must prove the elements of the claim. The liability will not be enforceable until such time as the court makes an order against the director.

WHAT ARE THE DEFENCES AVAILABLE TO DIRECTORS?

Section 588H of the Corporations Act sets out the available defences. Directors will not be liable if they can establish one of the following:

- They had reasonable grounds to expect that the company was solvent.
- They did not participate in management of the company, due to illness or some other good reason.
- They took all reasonable steps to prevent the company from incurring the debt.

WHAT ARE 'ALL REASONABLE STEPS'?

A court may consider the following matters when deciding whether a director took 'all reasonable steps':

1. *'any action the person took with a view to appoint an administrator of the company; and*
2. *when that action was taken; and*
3. *the result of that action.'*

The appointment of a voluntary administrator or a liquidator will mitigate a director's exposure to an insolvent trading claim; but, it may not eliminate a claim for debts incurred prior to the appointment.

HOW LONG DO LIQUIDATORS HAVE TO TAKE AN INSOLVENT TRADING ACTION?

Liquidators have six years from the beginning of the liquidation to commence an action for insolvent trading. Proceedings must be initiated by way of an application to the court within that six-year period, merely issuing a demand for payment is not sufficient.

UNREASONABLE DIRECTOR-RELATED TRANSACTIONS

WHAT IS A DIRECTOR-RELATED TRANSACTION?

A director-related transaction includes:

- payments of money made by a company
- conveyances, transfers, or other dispositions of company property
- securities issued by the company
- incurred obligations to make such transactions.

To be 'director-related', a transaction must involve either:

- a company director
- a close associate of a company director
- a 'nominee' acting on behalf of, or for the benefit of, a director or their close associate.

MORE INFO:
UNREASONABLE DIRECTOR-RELATED TRANSACTIONS P55

WHEN IS A DIRECTOR LIABLE?

Directors will be liable to compensate a company for loss if they cause the company to enter into a director-related transaction that would have resulted in an 'unreasonable' benefit.

WHO IS A CLOSE ASSOCIATE?

Under section 9 of the Corporations Act a close associate is a relative or de facto spouse of a director, or a relative of a spouse, or de facto spouse, of a director.

WHAT MAKES A TRANSACTION UNREASONABLE?

A transaction is unreasonable if a reasonable person in the same circumstances as the company would not have entered into the transaction after considering:

- any benefits that the company may have obtained
- any detriment the company may have suffered
- any benefits that other parties to the transaction may have obtained
- any other relevant matters.

If a reasonable person who would not personally benefit from the transaction would not have entered into that transaction, the transaction is likely to be 'unreasonable'.

HOW IS A DIRECTOR MADE LIABLE?

A liquidator can make a demand upon a director to compensate the liquidator for the amount of the unreasonable transaction; however, in reality, the liquidator must prove the elements of the claim. The liability will not be enforceable until such time as the court makes an order against the director. The Corporations Act outlines the relief available, but the type of compensation is dependent on the transaction.

WHAT IS THE EFFECT WHEN A COURT ORDERS THE TRANSACTION?

If a court ordered the transaction, and it meets the criteria for an unreasonable director-related transaction, the director will be liable under section 588FDA of the Corporations Act, which states:

'(3) *A transaction may be an unreasonable director-related transaction under subsection (1):*
(a) *whether or not a creditor of the company is a party to the transaction; and*
(b) *even if the transaction is given effect to, or is required to be given effect to, because of an order of an Australian court or a direction by an agency.'*

HOW MUCH CAN BE RECOVERED?

A liquidator may claim the amount of loss suffered by the company as a result of the director entering into the transaction.

A director or close associate may be liable for more than the mere loss if any extra consideration is deemed reasonable when compared with the benefit received from the transaction. That is, if an asset was sold for undervalue to a director, the director would have to pay the extra consideration deemed reasonable for that asset.

WHAT IS THE APPLICABLE TIMEFRAME?

The transaction must also have occurred, or action was taken for the purposes of giving effect to the transaction, during the four years before the winding up commenced.

LOSS OF EMPLOYEE ENTITLEMENT CLAIMS

WHEN IS A DIRECTOR LIABLE?

Liquidators and employees have a right to claim against a director if a company entered into a transaction that reduced the amount of assets available to pay priority employee entitlements in a liquidation. These transactions are known as agreements or transactions to avoid employee entitlements.

WHAT AMOUNTS TO A CONTRAVENTION OF THE CORPORATIONS ACT?

Section 596AB of the Corporations Act states that:

'A person must not enter into a relevant agreement or a transaction with the intention of, or with intentions that include the intention of:

(a) *preventing the recovery of the entitlements of employees of a company; or*

(b) *significantly reducing the amount of the entitlements of employees of a company that can be recovered.'*

Directors contravene the Corporations Act if they intentionally cause a company to enter into one of these agreements or transactions. A contravention of section 596AB activates section 596AC and gives the liquidator the right to make a recovery claim.

HOW DOES A DIRECTOR BECOME LIABLE FOR THE CLAIM?

Directors become liable to either a liquidator or, in some circumstances, an employee, if:

1. the director contravenes section 596AB of the Corporations Act
2. the company is being wound up
3. company employees suffer loss or damage because of:
   (a) the contravention
   (b) action taken to give effect to an agreement or transaction involved in the contravention.

HOW MUCH CAN BE RECOVERED?

An amount equal to the loss caused by entering the transaction may be claimed. The loss is limited to the total of the priority employees' entitlements that cannot be paid due to the reduced available assets caused by the transaction, or agreement.

HOW ARE RECOVERED MONIES DISTRIBUTED?

Under the Corporations Act employees and other parties who would have been entitled to priority claims under section 560 are given priority.

TAXATION DEBTS

CAN DIRECTORS BE LIABLE FOR A COMPANY'S TAX DEBTS?

Yes. Directors are personally liable if a company fails to remit PAYG withholding tax or superannuation contributions by their due dates; however, personal liability can be avoided in certain circumstances. Directors may also be liable if the ATO needs to refund monies to a liquidator under the unfair preference provisions in section 588FGA of the Corporations Act.

MORE INFO:
DPN P66

No action is required by a creditor to make the guarantor liable under a personal guarantee agreement.

HOW DOES LIABILITY OPERATE WHEN PREFERENCES ARE RECOVERED FROM THE ATO?

Under section 588FGA of the Corporations Act directors are liable to the ATO for payments originally made by a company to the ATO, then set aside as preferential and refunded to the liquidator. That is, if a liquidator forces the ATO to return money, directors become liable to the ATO for that amount, as well as any costs the ATO is ordered to pay to the liquidator.

Liability extends to anyone who was a director at the time of the original payment to the ATO, not simply at the time the company was wound up.

WHAT ARE DIRECTORS' RESPONSIBILITIES?

These are set out under 'Director Penalty Notices' on page 66.

PERSONAL GUARANTEES

DOES AN INSOLVENCY ADMINISTRATION DISRUPT A PERSONAL GUARANTEE AGREEMENT?

No. A personal guarantee is a separate third party agreement between a director (the guarantor) and a creditor, where the guarantor agrees to pay company debts, usually in full, when they have not been paid. The validity of personal guarantees is not disrupted by the actions of liquidators or administrators. Generally, a creditor does not need to take any specific action to make a guarantor liable. However, a personal guarantee cannot be exercised while a company is under voluntary administration. Once that period ends, the guarantee can be exercised immediately.

WHAT ARE THE IMPLICATIONS IF A GUARANTOR PAYS A CREDITOR?

If a guarantor pays a creditor in full, the guarantor has the right to 'stand in the shoes of the creditor' under a right of subrogation. This replaces the creditor with the guarantor and means the guarantor has the same rights against the company as the creditor. The creditor must have been paid in full for any right of subrogation to exist, as this right does not exist partially.

WHEN DO DIRECTORS USUALLY ENTER INTO PERSONAL GUARANTEES?

Commonly, directors sign personal guarantees, with suppliers when they enter into a credit agreement, with guarantees found in the terms and conditions. Sometimes, guarantees are found in a separate document. Guarantees usually form part of any finance facilities with banks and other financial institutions.

DOES A COMPANY HAVE TO BE IN LIQUIDATION FOR A CLAIM TO BE MADE?

No. Because a personal guarantee is a separate agreement between a director and a creditor, the company does not need to be in liquidation, or even insolvent, for the guarantee to be exercised.

TIMING

Unreasonable director-related transactions must have been made in the four-year period before the winding up appointment.

Preferences in Liquidations

What are preferences?

Preferences are payments or transfers of assets that give a creditor an advantage over other creditors. Any payments or transfers made to a creditor before a liquidation may be recovered by liquidators in certain circumstances. Preferences are usually payments of money, although a variety of transactions could be deemed 'preferential'.

WHO MAY RECOVER PREFERENTIAL PAYMENTS?

Liquidators can recover preferential payments; however, recovery may require a court order to perfect the entitlement to recovery. Recovering preferences is not available to provisional liquidators, voluntary or deed administrators, or receivers and managers.

WHY DO LIQUIDATORS VOID PREFERENTIAL PAYMENTS?

The liquidator's main role is to distribute a company's assets between its creditors on an equal basis (*pari passu*). Liquidators must determine whether any creditor received treatment, prior to liquidation that was not equitable compared to the distribution to other creditors in the liquidation. Liquidators can void transfers that involve one creditor to make a more equitable distribution to all creditors, including the creditor who received the preference.

WHAT ARE THE ELEMENTS OF A PREFERENTIAL PAYMENT?

When considering whether a payment is preferential, a court must be satisfied that:

1. a transaction was entered into (this is usually a payment of monies)
2. was between the company and a creditor of the company
3. happened when the company was insolvent
4. happened within the statutory period before the liquidation started
5. the transaction gave the creditor an advantage over other creditors
6. the creditor suspected, or had reason to suspect, that the company was insolvent.

WHEN IS A COMPANY INSOLVENT?

The definition of solvency is being able to pay one's debts as and when they fall due. Conversely, if a company is not solvent, it is therefore insolvent. In the context of preferences, the company must have either been insolvent at the time of the transaction or became insolvent because the transaction was made. The reasoning is that a solvent company has the capacity to pay all of its debts (whether they actually did or not) and therefore no creditor could have been advantaged over others.

WHO HAS TO PROVE INSOLVENCY?

The onus of proving insolvency lies with the liquidator.

THE MAIN ELEMENTS OF A PREFERENCE

1. There must be a debtor–creditor relationship

The transfer of property must have involved or been done at a creditor's direction, and must satisfy a debt that would be a provable debt if the transfer had not been made. A cash-on-delivery (COD) payment for goods is not a payment to a creditor, so is never deemed preferential.

However, suppliers often supply goods on COD with a requirement for further payment towards satisfying an existing debt. This additional payment is deemed preferential and is therefore recoverable by a liquidator.

An advance payment for future works, or the future supply of goods, cannot be preferential, but would be required to be repaid to the liquidator if the services/products have not been used by the company.

2. There must be a transaction

There must be a transaction between the company and creditor. Commonly, a transfer is a payment from a company's bank account, although any asset passing from a company to a creditor is sufficient to establish a transaction.

For example, the return of stock that is not subject to the *Personal Property Securities Act 2009* (PPSA), or assignment of a debt, would be a transaction for the purposes of the preference provisions.

3. The relevant period

The transaction must have occurred during a specific period before the 'relation back-day'. The actual period depends on whether the recipient is related to the company, and on the company directors' intention.
The periods are:

- six months for non-related parties
- four years for related parties
- ten years for any evidence of 'attempt to defeat, delay or interfere' with the rights of creditors.

The relation-back day is the date that the liquidation is deemed to have started. For the various types of liquidations, the relevant days are:

- for a liquidation that follows a voluntary administration or Deed of Company Arrangement (DOCA), it is the day that the voluntary administrators were first appointed
- for other voluntary liquidations, it is the date of the members' meeting that the liquidators were appointed
- for a court appointment it is the day that the application was filed in the court.

4. The debt must be unsecured

A preference does not apply to a creditor holding a valid and subsisting security over company assets pursuant to the PPSA, where the value of the assets secured is greater than the payment amount. But, if the security is not properly created or registered, or the value of the security is less than the payment amount, the liquidator may render it void and the debt may be deemed unsecured.

Other provisions also apply to securities provided to related entities and created within six months of the start of the liquidation. The creation of a security itself within the six months can also be a preference.

MORE INFO:
PPSA P72

5. Continuing business relationship

The continuing business relationship provision is similar to what was previously known as a 'running account'. The business relationship provision is used to determine the amount of any preference received by a particular creditor; it takes into account all transactions between relevant dates. It shows whether the owed debt increased or decreased to the creditor during that period.

If the balance owing decreased, this amount is the potential preference amount, with all other factors being considered. If the balance owing increased, there is no preference as the creditor is actually disadvantaged by the transactions.

The liquidator determines the start date and concludes on the date the winding up commenced.

6. The creditor must obtain a preference

The creditor must have received more than they would have received if they refunded the monies and proved for that amount in the liquidation process. If the creditor did not receive more by way of the payment than they would have received from a dividend, there is no advantage or preferential treatment.

WHAT DEFENCES ARE AVAILABLE TO CREDITORS?

Section 588FG of the *Corporations Act 2001* provides defences that may be available to creditors who received preferential payments. To rely on a defence, a creditor must be able to satisfy all three conditions of the defence. The onus of proving the defences is on the creditor, it is not for the liquidator to disprove them.

The three conditions of the statutory defence are:

1. the creditor gave valuable consideration for the payment
2. the creditor received the payment in good faith
3. the creditor had no reason to suspect the insolvency of the company.

Each of these conditions is outlined as follows.

1. What is valuable consideration?

Usually, the easiest condition to prove is the creditor gave valuable consideration. For trade creditors, the initial supply of goods or services provides the valuable consideration. A loan creditor can rely on the initial loan to the company. The creditor will only have to show that they have given something of value in consideration for receiving the payment.

2. What is good faith?

The creditor must not have acted in any manner that would indicate they were not acting in good faith or under normal trading conditions. Actions that may repute good faith are: commencing proceedings or issuing statutory notices; ceasing supply; or changing to a COD basis. They must not have forced the payment by any form of threat or action.

3. What is needed to suspect insolvency?

The creditor must not have received or have known of any information or circumstance that would lead them (or a reasonable person in their position) to suspect that the company was insolvent. It is not necessary that the creditor knew, or believed, or even expected that the company was insolvent to lose the benefit of this defence. The mere suspicion of a reasonable person is enough.

Actions such as receiving post-dated cheques, dishonouring cheques, entering into repayment agreements, knowing of other creditors that are unpaid and pressing for payment can reasonably lead to this suspicion. Whether or not a person should have suspected insolvency is often difficult to determine particularly as the courts recognise a distinction between a short-term cash-flow problem and insolvency.

Any payments or transfers made to a creditor prior to the liquidation may be recovered by liquidators in certain circumstances.

WHAT SHOULD CREDITORS DO IF A LIQUIDATOR CLAIMS A PREFERENTIAL PAYMENT?

Creditors should ensure that:

1. the transaction was entered into within the relevant period
2. they are not a secured creditor
3. they are (or were) a creditor when the transaction was made, and that it was not a cash on delivery payment
4. the liquidator demonstrates they received an advantage over other creditors by virtue of the payment.

These basic points are usually easy to demonstrate. The following points are more difficult to determine:

1. whether the creditor gave extra credit to the company after the payment or transfer was received, whether it is possible that the claim may be reduced or eliminated by the amount of extra credit granted, that is, to determine whether the creditor had a continuing business relationship with the company
2. that the liquidator can show insolvency at the time of, or before the payment was received
3. whether the creditor has a realistic chance of convincing the liquidator that the statutory defences apply.

WHAT CAN CREDITORS DO IF REQUIRED TO REFUND MONEY TO A LIQUIDATOR?

Creditors refunding preferences may lodge a proof of debt with the liquidator for the amount refunded. They may also have some rights under any guarantees.

HOW LONG DOES THE LIQUIDATOR HAVE TO MAKE A CLAIM?

Claims must be commenced within three years after the relation-back day. A liquidator must issue proceedings within three years—not just make a formal demand. A time extension may be granted by the court, but the application must be made within the three-year period after the relation-back day, and the liquidator must demonstrate a reasonable cause for the delay in initiating the claim.

TIMING

Relation-back day for each administration type:

Liquidation (that follows VA/DOCA)—voluntary administrator's appointment date.

Voluntary liquidations—1st members meeting that appointed voluntary administrator.

Court liquidation—application filed in court.

Relation-back day:

6 months for non-related parties.

4 years for related parties.

10 years for 'attempt to defeat, delay or interfere' with creditor's rights.

Preferences claims must be made within the 3-year period following the relation-back day.

Insolvent Trading

Insolvent trading claims: **temporary liquidity or endemic shortage**

Stress or Distress—try explaining to the Judge.

In 2016, the insolvent trading legislation attracted publicity due to the Turnbull Government's Innovation Agenda, which proposes enacting 'safe harbour' provisions to give directors some protection. Unless and until such legislative reform is enacted, directors must deal with the current regime, which is inevitably the subject of detailed consideration by directors of companies in difficult financial circumstances. Unfortunately, limited authorities provide practical guidance as to how directors should approach the issue.

Section 588G of the *Corporations Act 2001* provides that a person has engaged in insolvent trading if, in general terms:

- The person is a director when a company incurs a debt.
- The company was insolvent or became insolvent when the debt was incurred.
- The director had reasonable grounds to suspect the company's insolvency.
- A reasonable person would be aware of the company's insolvency.

If a company is placed into liquidation and the liquidator or a creditor initiates an insolvent trading action, directors can defend claims under the Corporations Act defence provisions.

One defence is that the director had reasonable grounds **to expect and did expect** that the company was solvent and would remain solvent even if it incurred that debt and other debts (incurred at the same time).

In this case, a director must establish they had a measure of confidence or a positive expectation that the company was solvent, and **not** a mere hope.

Insolvent Trading

At the junction when a company experiences any degree of financial stress, directors and their advisors must pause to reflect and ask themselves:

Is the company experiencing a **temporary liquidity** problem (i.e. a state of stress) or, is the company experiencing an **endemic shortage** of working capital (a state of distress)?

An objective assessment (to the required standard of reasonableness) to answer this question is key to a director properly defending themselves against an insolvent trading claim.

Notably, when a liquidator considers making an insolvent trading claim, it is with the benefit of hindsight, and often in circumstances where the directors have sought, and failed in securing various funding solutions (as otherwise the company would not be in liquidation).

Frequently, the director will have a three-way forecast (prepared with their accountant) that brings together the Profit and Loss (P&L), Balance Sheet, and cash flow statement for the review period (usually 12 months). The benefit of the three-way forecast is that it forms the foundation for the insolvency assessment—**can the company pay all its debts as and when they fall due**. A three-way forecast integrates opening balance sheet items (notably, debtors, creditors, stock, cash) to reveal the weekly/monthly cash position, while considering the underlying assumptions of the P&L, debtor days, creditor payments etc.

Two key areas need careful attention in preparing a three-way forecast:

Creditor payments

Unless arrangements are in writing, the three-way forecast should reflect the creditor's current repayment terms. Extended creditor payment terms cannot be included in the cash-flow forecast unless such extended terms are in writing.

Sale of an asset

Often companies have surplus assets in the form of plant and equipment, land and buildings etc. The sale of such assets can recapitalise a business and restore solvency. However, merely identifying and intending to sell surplus assets is insufficient to include the anticipated cash proceeds in the cash forecast.

In this regard, the guidelines for assessing temporary liquidity vs endemic shortage of working capital in *Hall v Poolman [2007] NSWSC 1330* are helpful. In that case, the Judge found that a **director would be justified in "expecting solvency" if an asset could be realised to pay creditors in full within three months**.

When considering whether a director could rely upon such an asset sale in the 'reasonable expectation of solvency' defence, the Court contemplated three levels of expectation that a director may have to an asset being realised:

1. Certain or Probable.
2. More likely than not.
3. Possible or no way of knowing.

The Court determined in *Hall v Poolman* that only where the facts supported an asset realisation as "Certain or Probable" could the directors successfully defend an insolvent trading claim.

Therefore, merely recognising surplus assets that could be realised to overcome a liquidity crisis, is insufficient to qualify as an insolvent trading defence; nor is it sufficient, for example, to list a company premises for sale, and rely on that action itself as a defence that funds will become available to the company. Rather, for directors to have a viable defence they must be satisfied (i.e. on reasonable grounds—most likely third party advice) that sale proceeds are "certain". This means that there is a reasonable expectation of the asset being sold (but subject to settlement) within 90 days.

Directors risk their personal assets if they trade when their company cannot pay its debts "as and when they fall due". Therefore, directors of companies in difficult financial circumstances should examine its cash-flow forecasts to support continued trading (and solvency). Critically, directors should understand:

- the creditor terms assumed in the forecast, and in particular whether extended creditor payments terms are unilaterally assumed or have been agreed to in writing by the creditor; and/or
- whether forecast assets realisations are based on a high degree of certainty or probability (and in particular, would those assumptions withstand a 'hindsight' analysis).

TIMING

An insolvent trading claim must be made in court within 6 years of the liquidation commencing.

What is insolvent trading?

Insolvent trading is when directors allow their company to incur debts when the company was insolvent. The liquidator can make a compensation claim against a director if those debts are unpaid when the liquidation commences. A director may be held personally liable to compensate creditors for the amount of the unpaid debts incurred from the time the company became insolvent to the start of the liquidation.

WHY DO LIQUIDATORS MAKE THESE CLAIMS?

Liquidators are obliged under the provisions of the *Corporations Act 2001* to investigate the existence of any insolvent trading claim, and if so, take appropriate action. Further, directors have a duty to stop a company from incurring debts it is unable to pay. Under the Corporations Act, failing to stop a company from incurring debts it is unable to pay is a breach of the directors' duty. Directors may have to pay compensation to the company for losses creditors have incurred under that breach of duty.

WHO MAKES INSOLVENT TRADING CLAIMS?

Liquidators have the first opportunity to make insolvent trading claims. If they decide not to make a claim, creditors may start their own actions, but creditors' claims are limited to the amount of their individual debt.

CAN CREDITORS TAKE INSOLVENT TRADING ACTION?

Yes. If a liquidator does not pursue an insolvent trading claim, the creditors of the company (individually or in a group) can make a claim. Creditors may start an action either with a liquidators consent or if the liquidator fails to provide their consent, the creditors can seek leave of the court in certain circumstances.

Creditors can only take action against directors for their own debts. Whereas a liquidator can pursue an insolvent trading claim on behalf of all creditors' unpaid claims. A creditor cannot commence action when a liquidator has already begun proceedings or has intervened in an application for a civil penalty order. That is, claims are restricted when the liquidator has started their own action.

WHAT ARE THE FACTORS IN AN INSOLVENT TRADING CLAIM?

Aside from the company being in liquidation, the factors in an insolvent trading claim are:

1. The company must have been insolvent when the debts were incurred.
2. The debts must remain unpaid at the time of the liquidation.
3. The claims must be made against people who were company directors at the time debts were incurred.
4. There were reasonable grounds for the director to suspect the company was insolvent.

WHO ARE DIRECTORS?

The status of 'director' of a company is not exclusive to those who are appointed as directors, recorded in the company register, or those notified to the Australian Securities and Investments Commission (ASIC). People who act as a director, even if not formally appointed, may be defined as a director. Shadow or de facto directors, or other parties that controlled the company at the time the company became insolvent can be exposed to an insolvent trading claim.

The Corporations Act defines a 'director' as:

'(a) a person who:

(i) is appointed to the position of a director; or
(ii) is appointed to the position of an alternate director and is acting in that capacity; regardless of the title of their position; and

(b) unless the contrary intention appears, a person who is not validly appointed as a director if:

(i) they act in the position of a director; or
(ii) the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes.'

The definition excludes people who give advice as part of their normal professional role. For example, accountants, solicitors and other paid consultants.

WHEN IS A COMPANY INSOLVENT?

A company is insolvent when it cannot pay its debts as and when they become due and payable. The Corporations Act defines solvency and insolvency as:

Section 95A – Solvency and Insolvency

(1) *A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.*
(2) *A person who is not solvent is insolvent. A person is defined to include a corporation.*

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WHAT ABOUT ACCRUED DEBTS?

For an insolvent trading claim, the debt must be incurred, not just accrued, when the company is insolvent. Incurring a debt is the legal creation of a debt that did not previously exist. Accrued debts usually relate to ongoing contractual agreements.

Contractual agreements are incurred at the time of the original agreement and only become payable (or accrue) at a later date. If the original agreement was made while the company was solvent, and the later amounts only accrue because of that original contract, those debts will not form part of an insolvent trading claim. For example, reoccurring lease payments are under a contract that was entered into prior to the company's insolvency.

HOW DO DIRECTORS BECOME LIABLE FOR INSOLVENT TRADING CLAIMS?

Section 588G of the Corporations Act sets out the director's duty to prevent insolvent trading and sets the parameters by which a liquidator can initiate the process for making a claim against a director. Directors contravene this section by allowing the company to incur a debt when they are aware of grounds to suspect the company was insolvent.

When directors breach their duty, the provisions of section 588M allow compensation to be recovered from that director. A claim is possible where the creditors suffered loss or damage because of the company's insolvency and the debt was wholly or partly unsecured.

An insolvent trading claim may be referred to ASIC for further investigation and potential criminal prosecution.

WHAT DEFENCES ARE AVAILABLE TO DIRECTORS?

The Corporations Act provides statutory defences for directors. The burden of proving these defences is on directors. The statutory defences can be summarised as:

1. the director had reasonable grounds to expect (not just suspect) the company was solvent
2. a reasonable, competent person produced information that would reasonably lead to a belief that the company was solvent
3. the director had a good reason for not taking part in the company management at the relevant time
4. the director took all reasonable steps to stop the company incurring the debt, including attempting to appoint a voluntary administrator to the company.

The courts have made it clear that the position of director carries certain responsibilities, which cannot be avoided, including the duty to keep informed about the company's solvency.

IS INSOLVENT TRADING AN OFFENCE?

Yes. Insolvent trading is an offence and can be referred to ASIC for further investigation and possible criminal prosecution. Directors should seek legal advice. Section 588G (Director's duty to prevent insolvent trading by company) stipulates:

(3) *A person commits an offence if:*

- (a) *the person is a director of the company when it incurs a debt; and*
- (b) *the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and*
- (c) *the person suspected at the time when the company incurred the debt that the company was insolvent or would become insolvent as a result of incurring that debt or other debts (as in paragraph (1)(b)); and*
- (d) *the person's failure to prevent the company incurring the debt was dishonest.*

HOW LONG DO LIQUIDATORS HAVE TO TAKE ACTION FOR INSOLVENT TRADING?

Liquidators have six years from the beginning of the liquidation to commence an action for insolvent trading. Proceedings must be commenced by way of the filing of an application with the court within that six-year period. It is not sufficient to just issue a letter of demand.

WHAT SHOULD DIRECTORS DO IF A LIQUIDATOR MAKES AN INSOLVENT TRADING CLAIM?

A liquidator should be asked to demonstrate:

1. that the company was insolvent during the appropriate period
2. that the debts were incurred after that time
3. proof of director status at that time, whether formally appointed or not.

In settling claims with the liquidator, the settlement must be sanctioned by the court, usually by way of a consent order. This consent order protects directors from any future claims made by creditors of the company.

Unreasonable Director-related Transactions

What is an unreasonable director-related transaction?

A transaction that has little or no benefit to the company that is made by a director or close associate (as defined by the *Corporations Act 2001*) of the company is called an 'unreasonable director-related transaction'. Under the Corporations Act, the other party to the transaction is required to return the asset or make a payment to the liquidator.

WHO RECOVERS AN UNREASONABLE DIRECTOR-RELATED TRANSACTION?

Only liquidators may recover unreasonable director-related transactions. Unreasonable director-related transactions cannot be recovered by provisional liquidators, voluntary administrators, deed administrators or controllers.

WHAT IS THE BASIS OF THE CLAIM?

The liquidator must prove that:

1. a transaction was entered into
2. a director or close associate of the director was involved in the transaction
3. either there was no benefit to, or there was a detriment to the company.

WHY RECOVER AN UNREASONABLE DIRECTOR-RELATED TRANSACTION?

A liquidator will examine whether the company entered into any transactions that reduced the amount of assets available for distribution in the liquidation.

A liquidator will seek recovery of money or assets transferred to make a more equitable distribution to creditors.

HOW MUCH CAN BE RECOVERED FROM AN UNREASONABLE DIRECTOR-RELATED TRANSACTION?

The liquidator will recover the difference between the value that was given by the company and the value received by the company. Only the excess between the two values is recoverable.

WHAT ARE THE MAIN ELEMENTS OF UNREASONABLE DIRECTOR-RELATED TRANSACTIONS?

There are two main elements to an unreasonable director-related transaction: the transaction, and the party involved.

1. The transaction

The transaction must involve the company. The transaction can be a payment; a transfer or disposition of property; a security, or incurring an obligation or commitment to make a payment, disposition or issue. Section 588FDA is designed to cover money or assets actually leaving the company, or commitments (like security interests) being made over money or assets.

2. A director or close associate must have been involved

The transaction must involve one of the following:

1. a director of the company
2. a close associate of a director of the company
3. a 'nominee' acting on behalf of, or for the benefit of, a director or their close associate.

Nominees are people who are trying to disguise their involvement by including another person to the transaction, but where the related party still receives the benefit.

WHO IS A DIRECTOR?

A director is defined under section 9 of the Corporations Act as:

(a) *a person who:*

(i) *is appointed to the position of a director; or*

(ii) *is appointed to the position of an alternate director and is acting in that capacity; regardless of the name that is given to their position; and*

(b) *unless the contrary intention appears, a person who is not validly appointed as a director if:*

(i) *they act in the position of a director; or*

(ii) *the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes.*

WHO IS A CLOSE ASSOCIATE?

A close associate is:

- a relative or de facto spouse of a director, or
- a relative of a spouse or of a de facto spouse, of the director. A relative is a spouse, parent or remoter lineal ancestor, son, daughter or remoter issue, or brother or sister of the person.

HOW IS A TRANSACTION CONSIDERED TO BE UNREASONABLE?

The company must benefit from the transaction for it to be considered 'reasonable'. Therefore, if the benefits of the transaction are outweighed by the detriment of the transaction to the company, it is deemed unreasonable. The liquidator will look for a reduction in the net position of company assets caused by the transaction to determine whether it is reasonable or not.

WHAT IS A REASONABLE PERSON TEST?

The court will look at the transaction from the view of a 'reasonable person' in the company's circumstances. This is someone that has knowledge of the company's financial position, who is not trying to gain a personal benefit, or give a benefit to anyone else, or cause a loss to the company. It is assumed that a reasonable person would not enter into a company transaction that would cause detriment to the company or reduce its assets.

WHAT PERIOD IS INVOLVED?

The transaction must have been entered into within four years before the 'relation-back day', or between the relation-back day and the appointment date. The relation-back day is the day that the liquidation legally commences. There are three possible dates for the relation-back day in corporate administrations:

1. For a liquidation following a voluntary administration, the relation-back day is when the administrators were first appointed to the company, even if a Deed of Company Arrangement (DOCA) was in effect in the intervening period.
2. For a court appointment, the relation-back day is the day the application was filed.
3. For a creditor's voluntary winding up, the relation-back day is the date of the members' meeting that resolved to wind up the company.

DOES THE COMPANY NEED TO BE INSOLVENT?

No. The company does not need to have been insolvent at the time of the transaction or because of the transaction. This means the statutory defences available in other recovery actions—such as the good faith defence and no reasonable grounds to suspect insolvency do not apply.

WHAT RELIEF IS AVAILABLE TO THE LIQUIDATOR?

Recovery applications are limited to a relief available under section 588FF of the Corporations Act. The most common relief sought by liquidators is the return of the monies or assets received by the other party. However, recovery is limited to the excess or the unreasonable benefit of the transaction. The whole transaction is not voided, unless there was no 'reasonable' part to it. Therefore a recovery is generally the payment of money.

HOW LONG DOES THE LIQUIDATOR HAVE TO MAKE A CLAIM?

A claim application for an unreasonable director-related transaction must be made within three years after the relation-back day. It is insufficient for the liquidator to only have issued a demand within that period, legal proceedings must be commenced within the three years.

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TIMING

Relation-back day for each administration type:
Liquidation (that follows VA/DOCA)—voluntary administrator's appointment date.
Voluntary liquidations—1st members meeting that appointed voluntary administrator.
Court liquidation—application filed in court.

Relation-back day:
6 months for non-related parties.
4 years for related parties.
10 years for 'attempt to defeat, delay or interfere' with creditor's rights.
These claims must be made within the 3-year period following the relation-back day.

Uncommercial Transactions

What are Uncommercial Transactions?

Liquidators investigate transactions they believe were not beneficial to, or were in fact, detrimental to the company. These types of transactions are called uncommercial transactions. The *Corporations Act 2001* allows these transactions to be voided and sets out the way the other party to the transaction is to return an asset, or make a payment to the liquidator.

WHO MAY VOID UNCOMMERCIAL TRANSACTIONS?

Only liquidators may seek to void uncommercial transactions. This recovery is not available to provisional liquidators, voluntary administrators, deed administrators or controllers.

WHAT MAKES AN UNCOMMERCIAL TRANSACTION VOIDABLE?

The transaction must have:

1. no financial benefit to the company, or was detrimental to the company
2. occurred when the company was insolvent
3. involved another party who should have suspected the company was insolvent.

WHY VOID UNCOMMERCIAL TRANSACTIONS?

A liquidator must make an equitable distribution of the company's assets to its creditors. If the company entered into a transaction that reduced the assets available for distribution to creditors, a liquidator will recover these assets, or its monetary equivalent.

WHAT IS THE TRANSACTION?

Generally, uncommercial transactions are sales, transfers, or purchases of assets or services. What can be a transaction is broad, but there must be an identifiable event between the parties.

WHAT MAKES A TRANSACTION UNCOMMERCIAL?

A transaction is uncommercial if it had no or limited financial benefit, or was detrimental to the company's financial position. If the transaction reduced the company's net asset position, the transaction is uncommercial. The 'reasonable person test' can assist to test the situation.

Two main circumstances that make an uncommercial transaction are when:

1. The company disposes of property for less than its true value.
2. The company purchases property at a price for more than its true value.

Usually, these types of transactions are made with related entities to the company.

MUST THE COMPANY BE INSOLVENT AT THE TIME?

The company must have either been insolvent at the time of the transaction, or became insolvent because of the transaction. Section 95A of the Corporations Act defines insolvency as not being able to pay debts as and when they fall due. The reasoning is the company must be insolvent, as a solvent company can pay all of its debts and therefore the transaction cannot cause detriment to creditors.

WHAT IS A 'REASONABLE PERSON' TEST?

The court will look at the transaction from the view of a 'reasonable person' in the company's circumstances. This is someone that has knowledge of the company's financial position, who is not trying to gain a personal benefit, or give a benefit to anyone else, or cause a loss to the company. It is assumed that a reasonable person would not enter into a company transaction that would cause detriment to the company or reduce its assets.

WHAT PERIODS ARE APPLICABLE?

Three periods apply to when the transaction happened, and before the 'relation-back day' during which the transaction must occur. These are:

1. six months—for non-related parties
2. four years—if the recipient is related to the company
3. ten years—if there is any 'attempt to defeat, delay or interfere' with creditors' rights.

The relation-back day is the day that the liquidation commenced. For a liquidation that follows a voluntary administration, it is the day the administrators were first appointed. For other voluntary liquidations, it is the date of the members meeting held to wind up the company. For an official liquidation (a court appointment) it is the day that the application was filed in the court.

WHAT DEFENCES ARE AVAILABLE TO THE OTHER PARTIES TO TRANSACTIONS?

Section 588FF of the Corporations Act sets out the statutory defences available to the parties to a transaction. The other party to the transaction must prove all three parts of the defence.

The three parts of the statutory defence are:

1. valuable consideration was given
2. the party acted in good faith
3. there was no reason to suspect insolvency.

The other party must be able to prove all three parts of the statutory defence. The onus is on that party to prove their defence, the liquidator does not have to disprove the defence.

WHAT IS VALUABLE CONSIDERATION?

Usually, the easiest condition to prove is the creditor gave valuable consideration. For trade creditors, the initial supply of goods or services provides the valuable consideration. A loan creditor can rely on the initial loan to the company. The creditor will only have to show that they have given something of value in consideration for receiving the payment.

WHAT IS GOOD FAITH?

The creditor must not have acted in any manner that would indicate they were not acting in good faith or under normal trading conditions. Actions that may repute good faith are: commencing proceedings or issuing statutory notices; ceasing supply; or changing to a cash on delivery (COD) basis. They must not have forced the payment by any form of threat or action.

WHAT IS NEEDED TO SUSPECT INSOLVENCY?

The creditor must not have received or have known of any information or circumstance that would lead them (or a reasonable person in their position) to suspect that the company was insolvent. It is not necessary that the creditor knew, or believed, or even expected that the company was insolvent to lose the benefit of this defence. The mere suspicion of a reasonable person is enough.

Actions such as receiving post-dated cheques, dishonouring cheques, entering into repayment agreements, knowing of other creditors that are unpaid and pressing for payment can reasonably lead to this suspicion. Whether or not a person should have suspected insolvency is often difficult to determine particularly as the courts recognise a distinction between a short-term cash-flow problem and insolvency.

HOW LONG DOES THE LIQUIDATOR HAVE TO MAKE A CLAIM?

A claim application for an uncommercial transaction must be made within three years after the relation-back day. It is insufficient for the liquidator to only issue a demand within that period. The court can grant an extension, but the court application must be made within the three-year period after the relation-back day, and the liquidator must show the court a reasonable reason, for the delay in initiating the claim.

TIMING

Relation-back day for each administration type:	Relation-back day:
Liquidation (that follows VA/DOCA)—voluntary administrator's appointment date.	6 months for non-related parties.
Voluntary liquidations—1st members meeting that appointed voluntary administrator.	4 years for related parties.
Court liquidation—application filed in court.	10 years for 'attempt to defeat, delay or interfere' with creditor's rights.
	These claims must be made within the 3-year period following the relation-back day.

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Indicators of Insolvency

Overview

Frequently, the courts assess whether or not a company or individual is insolvent and if so, when that insolvency started and when various stakeholders should have suspected it. It is also a critical factor for directors, when liquidators or creditors commence recovery actions for damages arising from insolvent trading or related claims.

In *ASIC v Plymin (2003) 46 ACSR 126*, the Judge referred to a checklist of 14 indicators of insolvency.

These indicators were identified as:

1. Continuing losses
2. Liquidity ratio below 1
3. Overdue Commonwealth and State taxes
4. Poor relationship with present bank including inability to borrow further funds
5. No access to alternative finance
6. Inability to raise further equity capital
7. Suppliers placing the debtor on cash on delivery (COD) terms, or otherwise demanding special payments before resuming supply
8. Creditors unpaid outside trading terms
9. Issuing of post-dated cheques
10. Dishonoured cheques
11. Special arrangements with selected creditors
12. Solicitors' letters, summonses, judgments, or warrants issued against the company
13. Payments to creditors of rounded sums, which are not reconcilable to specific invoices
14. Inability to produce timely and accurate financial information to display the company's trading performance and financial position and make reliable forecasts.

1. CONTINUING LOSSES

Not every business that makes a loss, or a series of losses, is insolvent. When working capital is available to meet losses, insolvency can be avoided. Losses alone do not cause insolvency. Rather, insolvency is usually a combination of losses, and insufficient working capital.

Solely concentrating on losses without considering the company's/business's capacity to absorb those losses may not give a true picture of the solvency position. However, if the loss is significant enough, or over a long enough period, the ability of the company to absorb those losses is eliminated.

2. LIQUIDITY RATIO BELOW 1

Liquidity measures the extent to which liquid assets are available to cover payable debts. A business liquidity ratio compares its current assets and current liabilities. If the ratio is greater than 1, this means there is more liquid assets than payable debts and indicates the business should be able to pay debts from its available assets. If the ratio is less than 1, the converse principle applies.

While the liquidity ratio provides a pointer to solvency, it is not a conclusive indicator. A liquidity ratio measures available assets at a specific time and does not factor in the dynamics of cash-flow or whether a debt is actually payable at that time. Some other factors that need to be considered is that the ratio usually uses funds in the bank, rather than allowing for possible borrowed funds and available overdraft facilities also need to be considered. Further, a liquidity ratio does not allow for whether some assets (such as stock and receivables) are truly liquid.

Business owners should examine the reasons for a liquidity ratio below 1, and decide whether action is needed.

3. OVERDUE COMMONWEALTH AND STATE TAXES

Many businesses regard the non-payment of taxes as the easiest way to save cash-flow and survive. This is commonly referred to as 'borrowing the money from the government'. The rationale is that unlike general lending terms there are no application forms, no valuations, and no bank fees. In addition, there is no recourse of non-supply or repossession, and the application of interest can be delayed or negotiated.

Non-payment of tax commitments (GST or PAYG withholding) is a good indicator of insolvency. In most cases businesses that do not pay tax, cannot pay tax. Business owners should consider whether they are insolvent when taxes remain unpaid.

4. POOR RELATIONSHIP WITH PRESENT BANK INCLUDING INABILITY TO BORROW FURTHER FUNDS

Banks have a distinct advantage over other creditors. Banks know what funds are available and can analyse the flow of funds through a business account. If the business borrowed money from the bank, the business owners regularly provide the bank with financial information. Usually, none of this information is available to other creditors.

A poor relationship with a bank usually stems from:

1. The non-repayment of monies due
2. The bank regularly dishonouring cheques
3. The bank's assessment of the financial position, or management of the business.

A poor relationship with a bank does not prove that the business is insolvent, just as a good relationship is not proof of solvency. The bank may also be unaware of a business's insolvency, because the business has operated within the bank's agreed limits, while not paying other creditors.

The bank's lack of confidence in the business and its solvency can create a poor relationship. Certainly, if a bank refuses to advance further funds or calls up a loan or overdraft, its reason must be clear. If a bank refuses further funding it may, and often does, cause insolvency.

5. NO ACCESS TO ALTERNATIVE FINANCE

Typically, two finance solutions are available to businesses in need of capital:

1. The debtor can convert short-term debt to long-term debt, which can be repaid on a certain date, or intermittently, over a period. If a debt is no longer 'due and payable' it will not form part of a strict solvency calculation.
2. Businesses may borrow funds to pay due debts. This creates a new debt to pay an old debt. Care must be taken not to mislead the lender, even if the loan is to satisfy the current debt and alleviate a current cash-flow problem. If the business later fails, the new loan may have personal liability consequences for the business owner.

6. INABILITY TO RAISE FURTHER EQUITY CAPITAL

An equity investor can inject funds into the business. Investors seek an eventual return from profits, and do not compete with the repayment priority of debts. Diligent equity investors will review the business finances and prospects to be satisfied that the return is commensurate with the risk.

An inability to use these finance solutions is a strong indicator that a business has a cash-flow problem and is possibly insolvent.

If business owners cannot get funding to pay outstanding debts, they should suspect insolvency.

7. SUPPLIERS PLACING THE DEBTOR ON COD TERMS, OR OTHERWISE DEMANDING SPECIAL PAYMENTS BEFORE RESUMING SUPPLY &

8. CREDITORS UNPAID OUTSIDE TRADING TERMS

Creditors are the first to know that their invoices are not being paid on time. An efficient business will have systems to identify overdue accounts, and prompt collection action. Collection may consist of collection letters, or calls, and limiting further supply to a cash on delivery (COD) basis, or ceasing supply entirely. Being placed on COD terms is a warning sign that the supplier is concerned with a business.

When there are many creditors with outstanding accounts, suspicion may be aroused that a business is insolvent. However, some businesses may habitually pay late, even when they have sufficient funds.

Business owners must determine whether debts are unpaid because there is no money, or whether there is another reason.

9. ISSUING OF POST-DATED CHEQUES

Issuing a post-dated cheque for a current debt is a classic sign of insolvency.

Understandably, some creditors view a post-dated cheque as a sign that their account will eventually be paid. However, issuing a post-dated cheque amounts to an admission of insufficient funds to pay at that time. Whether it also amounts to a creditor extending credit terms to the cheque date—is far less certain.

Solvent debtors rarely issue post-dated cheques. Therefore, these cheques should immediately raise suspicions of insolvency.

A debtor with a long history of issuing post-dated cheques is almost certainly insolvent and is relying on future monies to pay current commitments. Conversely, a debtor who infrequently resorts to post-dated cheques is more likely suffering a short-term, cash-flow problem, rather than insolvency.

10. DISHONOURED CHEQUES

Many post-dated cheques are dishonoured upon presentation. Generally, a cheque is dishonoured because there are insufficient funds available to cover the payment. On occasion, cheques can be dishonoured through no fault of the debtor. Therefore, one or two instances of dishonoured cheques should not be taken as clear evidence of insolvency.

However, when a debtor's bank repeatedly dishonours cheques a conclusion of insolvency is unavoidable. Business owners must quickly establish why their cheques are dishonoured, and determine if the business is solvent or not.

11. SPECIAL ARRANGEMENTS WITH SELECTED CREDITORS

Not all creditor demands end in court summons and judgments. If a debtor does not dispute a debt, but cannot make immediate payment, a creditor may enter into a repayment agreement.

Entering into a repayment agreement is an admission that a business cannot meet the full debt when due. Commonly, repayment agreements are successful and both parties are satisfied with the outcome.

A debtor can cure its insolvency by negotiating extended payment terms with a creditor provided the creditor makes a clear agreement to extend the terms. Once the debt terms are extended, the full amount is no longer due and payable.

12. SOLICITORS' LETTERS, SUMMONSES, JUDGMENTS, OR WARRANTS ISSUED AGAINST A COMPANY

One letter of demand from a creditor (or their solicitor) is not proof of insolvency, as there may be a dispute between the parties. However, a series of demands from various solicitors should create a strong presumption of insolvency. It is unusual for a business to have several disputes with their suppliers at the same time.

If the creditor progresses beyond the demand stage and obtains a judgment that remains unpaid, the presumption of insolvency is all but confirmed. When execution of the judgment is undertaken by the creditor, a state of insolvency is certain.

13. PAYMENTS TO CREDITORS OF ROUNDED SUMS, WHICH ARE NOT RECONCILABLE TO SPECIFIC INVOICES

Round payments can be made to reduce a debt, if the creditor agrees. However, it is common to find round amount payments being made without an agreement. Round payments are usually made because the debtor cannot pay the debt in full, and cannot negotiate extended arrangements with creditors, and extended credit terms become implied through part-payment. If business owners use small amounts of cash to pay large debts, they are likely to be insolvent.

14. INABILITY TO PRODUCE TIMELY AND ACCURATE FINANCIAL INFORMATION TO DISPLAY THE COMPANY'S TRADING PERFORMANCE AND FINANCIAL POSITION AND MAKE RELIABLE FORECASTS

Sections 286 and 588E of the *Corporations Act 2001* consider the issue of deeming a company is insolvent due to not keeping proper books and records.

If the company has failed to keep financial records in accordance with section 286 of the Corporations Act the company is to be presumed insolvent for the period to which the records have not been kept as required.

While the fact that the company has not prepared accurate financial statements may not necessarily mean that a company is insolvent, the courts have noted that a correlation exists between insolvency and deficient financial records. Not only do insolvent entities largely have inadequate accounting records, they also frequently show a reluctance to prepare reliable, and timely accounts.

Commonly, without financial information, business owners do not know the extent of the deficiency and will be unable to convince bankers, or other creditors, that they have a solution to their problem.

SUMMARY

How long can a short-term cash-flow problem last before it becomes a case of insolvency? A shortage of funds can only be described as a short-term cash-flow problem if it is certain it will be overcome in the short-term. Placing a timeframe on overcoming the problem is difficult, as some cash-flow problems are seasonal, or caused by specific contractual factors.

However, as a general rule a short-term cash-flow problem should be solved within three or four months with all debts being paid.

The insolvency date is a critical factor for directors, when liquidators or creditors commence recovery actions.

Director Penalty Notices

DPNs—know your SGC obligations

Lodge for the chance to avoid personal liability.

We often find many directors are issued with a DPN in respect of outstanding superannuation both prior to and following our appointment as external administrators over their company. Some DPNs provide 21 days for a director to take action in order to avoid personal liability ("non-lockdown") and some provide no time and having immediate effect ("lockdown").

The question then generally arises as to how this could happen and we proceed to explain to them the lay of the land. The conversation generally concludes with "What lodgement" or "What is a Superannuation Guarantee Charge Statement" and ends with the usual statement of "if only I had known that was required".

Here, we recap the position relating to superannuation and DPNs.

A company is required to complete a Superannuation Guarantee Charge statement if, within the relevant period, it did not pay sufficient superannuation contributions for its eligible employees by the quarterly cut-off date.

Table 1

Quarter	Cut-off date	Due date
1 July – 30 September	**28 October**	**28 November**
1 October – 31 December	**28 January**	**28 February**
1 January – 31 March	**28 April**	**28 May**
1 April – 30 June	**28 July**	**28 August**

The cut-off date is on the 28th day of the month following each quarter (Table 1) the company must pay an employee's superannuation guarantee entitlement to their fund.

If superannuation guarantee contributions are unpaid by this date, directors must lodge the Superannuation Guarantee Charge statement and pay the Superannuation Guarantee Charge.

The due date is the date that the Superannuation Guarantee Charge statement is to be lodged, being one calendar month after the cut-off date and is outlined in Table 1.

The required form to be completed and lodged with the ATO is available on its website **(Superannuation guarantee charge statement – quarterly (NAT 9599))**.

In summary, the DPN "lockdown provisions" work along the lines that if lodgement of the SGC Statement does not occur within three months of the due date (table 1)—the director penalty is permanently locked down automatically. The ATO can issue a DPN with immediate effect that cannot be discharged by appointing an administrator or liquidator.

If the client has lodged their SGC Statement on time (even if the payment hasn't been made) then the DPN that the ATO can issue is required to provide 21 days in order for action to be taken.

The key message for both advisers and their clients is "lodge for the chance to avoid personal liability".

Overview

Under the pay as you go (PAYG) withholding system, the *Income Tax Assessment Act 1997* (ITAA) requires companies to withhold money from wages to meet employees' tax liabilities to the Australian Taxation Office (ATO). Companies are also required to pay a superannuation guarantee charge (SGC) under the *Superannuation Guarantee (Administration) Act 1992* (SGA Act). Company directors are legally responsible for ensuring that their company meets its PAYG withholding and SGC obligations. If a company fails to comply with their obligations under the PAYG withholding system or the SGC provisions, company directors are held personally liable for the amount the company should have paid.

The laws governing the director penalty notice regime were strengthened significantly in June 2012. The net result is that it is now easier for directors to be pursued for these debts.

Under certain circumstances, the ATO can force directors of a company that is unwilling or unable to meet these obligations, to personally pay those debts. This is achieved with the issuance of a director penalty notice, for an amount equal to these amounts.

A director becomes liable to a penalty at the end of the day the company is due to meet its obligation. At this time, the penalty is created automatically. The ATO does not need to issue any notices or take any action to create the penalty. The Commissioner, however, must not commence proceedings to recover a director penalty until 21 days after a DPN is issued to a director.

There are two types of DPNs: non-lockdown penalty notice, and lockdown penalty notice.

Non-lockdown Director Penalty Notices

The first type is the "non-lockdown" directors penalty notice. Non-lockdown notices are issued to company directors that have lodged its business activity statements, instalment activity statements and/or superannuation guarantee statements within three months of the due date for lodgment, but the PAYG withholding and/or SGC debts remain unpaid. The notice gives directors 21 days to take certain actions, which results in the penalty being "remitted" i.e. cancelled.

Lockdown Director Penalty Notices

The second type is "lockdown" DPN (also referred to as the three-month lockdown provision). Lockdown notices are issued to company directors where a company has failed to lodge its business activity statements, instalment activity statements and/or superannuation guarantee statements within three months of their due lodgement date. In this case, the penalty permanently locks down on the director and there is no ability to remit (i.e. cancel) the penalty, other than by paying the debt in full.

PAYG WITHHOLDING NON-COMPLIANCE TAX

PAYG withholding non-compliance tax (NCT) is imposed on directors and associates of directors under the *Pay As You Go Withholding Non Compliance Tax Act 2012* (PAYG withholding NCT). The NCT is a 'tool of last resort' option for the Commissioner to pursue individual directors and their associates for an amount related to a company's unpaid PAYG withholding liabilities.

Payment by directors

Directors are liable to pay the NCT if they:

- were a director when the company failed to pay the withheld amounts on the date they were due
- became a director after the date the payment was due and they are still a director 30 days after the amount was due, but is still unpaid.

The amount of tax payable by the director is the lesser of:

- the total amount withheld from payments made to the individuals by the company in the year
- the company's PAYG withholding liability for payments made during the year.

The same defences for director penalties can also be used for NCT.

Payment by associates

An individual who is an associate of a company director can also be liable to pay PAYG withholding NCT if the company has not paid the outstanding amount by the last day for remitting.

An associate is defined in section 995-1 of the ITAA as having the same meaning as defined by section 318 of the *Income Tax Assessment Act 1936*, which defines associates as including relatives, partners, a spouse, or children of a 'natural person'. However, the Commissioner must determine that the associate knew, or could reasonably be expected to have known, that the company failed to pay the withheld amounts. The Commissioner must also be satisfied that the associate:

- did not take reasonable steps to influence the director to make the company notify the Commissioner about the amount withheld
- did not take reasonable steps to influence the director to make the company pay the withheld amounts to the Commissioner
- did not take reasonable steps to influence the director to appoint an administrator, or have the company wound up
- did not report that the company had not paid the amount withheld to the Commissioner or other relevant authority.

Recovering withheld amounts

The Commissioner must not give an NCT notice to a director who has a director penalty liability. A director must also have an entitlement to a PAYG withholding credit for an extent to an amount withheld by the company from payments made by the company to the director (such as directors fees).

The PAYG withholding NCT tax applies to amounts withheld during 2011-12 and later.

A director or an associate can object to any decision the Commissioner makes.

SUPERANNUATION

SGC obligations are due to be paid:

- when a company lodges its quarterly superannuation guarantee statement, or
- when the ATO quantifies an unreported SGC shortfall.

SGC obligations are payable on the same day a company lodges its quarterly superannuation guarantee statement with the ATO, generally 1 month and 28 days after the end of a quarter. However, the Commissioner can agree to a later payment date under section 33 of the SGA Act.

Directors may receive a director penalty at the end of the lodgement day (or the agreed lodgement date) if the company has not lodged its superannuation guarantee statement and paid the corresponding SGC by the end of that day.

ESTIMATES AND DIRECTOR PENALTY NOTICES

Where the company has failed to meet its reporting requirements for PAYG withholding and SGC, the ATO may issue a DPN based upon the ATO's estimate. Directors can submit a statutory declaration or an affidavit to verify the amount of the estimated liability, which may reduce or revoke the liability.

RECOVERING DIRECTOR PENALTIES

Director penalties are automatically imposed by the ATO. However, the Commissioner must follow a specific procedure before starting proceedings to recover that debt, as set out in the note to 269-20(2) of the *Taxation Administration Act 1953*. If the Commissioner determines it is 'fair and reasonable' for a director to pay the outstanding tax, they will issue a DPN. The Commissioner will not start proceedings to recover the debt until 21 days after the DPN is issued.

DPNs must be issued to an individual director. Directors are jointly and severally liable for the debt and will each owe the same amount of money under the DPN. The ATO considers that a DPN notice is issued on the day it is posted to the director's address listed in the company records maintained by the Australian Securities and Investments Commission (ASIC). If a DPN is delivered to an old address, it is still considered to be validly issued. The ATO may also send a copy of the DPN to the director's registered tax agent as an additional way of bringing the penalty to the director's attention; however, if the tax agent does not bring the notice to the director's attention, the notice is also still considered to be validly issued.

The ATO can also collect the tax in other ways, for example by withholding a tax refund or issuing a garnishee notice. The ATO has the power under section 260-5 TAA to issue a garnishee notice to any third party that owes or holds (e.g. the company's bank) any money on behalf of the company. A garnishee notice requires the third party to pay money directly to the ATO.

A garnishee notice can require payment of a percentage of the debt, or funds held, or may seek payment of a lump sum amount i.e. the full amount up to the ATO's debt. For individuals, this means that the ATO can issue a garnishee notice to an employer or contractor. For businesses, the ATO can issue a garnishee notice to a financial institution, or any trade debtor.

REMITTING DIRECTOR PENALTIES

Director penalties will be remitted if the company pays the outstanding tax at any time. Director penalties will also be remitted if, at any time on or before 21 days after a DPN is issued:

- The company reported its PAYG withholding or SGC liabilities to the ATO within three months of the due dates (i.e. it is a non-lockdown DPN); and
- The company goes into voluntary administration or liquidation.

However, if the company fails to report its PAYG withholding or SGC liabilities within three months of the due dates, the director penalties cannot be remitted even if an administrator or a liquidator is appointed. The DPN regime imposes a lockdown on a director for liabilities that are unpaid and unreported three months after the due date.

The strengthened director penalty regime commenced on 30 June 2012, and these remittance provisions apply to:

- PAYG withholding liabilities incurred after 30 June 2012.
- Un-extinguished PAYG withholding liabilities incurred before 30 June 2012.
- SGC liabilities incurred after 30 June 2012.

DEFENCES FOR DIRECTOR PENALTIES

A director is not liable for a director penalty if they can establish that one of the defences under the legislation is available to them.

A defence can be that due to illness or another acceptable reason, a director was not managing the company at the time the liability was incurred. This defence can be used if it is 'unreasonable to expect (the director) to take part due to illness (theirs or someone else's) or some other good reason'.

A director is also not liable for a director penalty if they can establish that they took all reasonable steps to:

- make the company meet its obligation to pay
- appoint an administrator
- wind the company up.

However, this defence is only acceptable if *no reasonable steps* were available. Unacceptable defences would include:

- the company had insufficient funds to pay the tax
- a consensus to appoint an administrator could not be reached.

For the SGC, a director may not be liable for a director penalty if they can establish that the company took reasonable care in trying to apply the SGA Act. This provision recognises that there can be some uncertainty about SGC liabilities, especially relating to employee entitlements. However, there is no corresponding defence for PAYG withholding obligations.

Directors cannot use a defence that a DPN was sent to the wrong address. The ATO use the address listed on the public record of the company with ASIC. The ATO considers directors are responsible to keep this information current.

There are two types of DPNs: non-lockdown penalty notice, and lockdown penalty notice.

Previous Directors

The ATO is able to issue a DPN to a director who has resigned before issuance of any notices.

Recently Appointed Directors

The ATO is also able to issue a DPN to a director who has recently joined the board, provided they have held office for more than 30 days at the date of issuance. This means that a newly appointed director is liable to pay all outstanding PAYG and SGC liabilities incurred by the company after 30 June 2012, as long as they have held office for more than 30 days. This includes shadow and de facto directors.

Where the company has failed to report its PAYG withholding or SGC liabilities within three months of the due dates, that personal liability permanently locks down on the newly appointed director three months after they commence as a director.

RIGHT OF INDEMNITY AND CONTRIBUTION

The legislation outlines the rights of a director who pays a company liability as against the other directors who were also liable to pay the penalties. To deal with the potential unfairness associated with recovering different amounts from company directors, a right of indemnity and contribution allows directors to recover amounts they have paid on the company's behalf against the company or its other directors.

Associates who have been levied with a PAYG withholding non-compliance tax also have right of indemnity and contribution, to claim back tax they have paid. However, no individual may recover their contribution from an associate.

The right of indemnity and contribution seeks to ensure that any one individual, particularly an associate, is not solely responsible for the financial burden caused by the company's failure to comply with its obligations.

TIMING

- 21 calendar days to remit a DPN.
- 3-months to lodge BAS, ISA and/or superannuation guarantee statements (of its due dates) (Non-lockdown DPN).
- 3-months to report BAS, ISA and/or superannuation guarantee statements (of its due dates) but remains unpaid (Lockdown DPN).

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Asset protection planning: Worrells' risk exposure checklist

Keep your hands off my assets!

Many new directors are completely oblivious of their obligations and duties, thinking only of what they will make from the successes of their new enterprise. They do not consider the downside or risk, particularly their exposure, should things go wrong.

The cold hard reality is company directors face many and varied potential risks. Some examples are discussed earlier in this Guide (Liquidation—the ugly side for directors page 36).

To many people, asset protection is about separating adverse risk from a person's assets. This means still being able to have some control over those assets even though the person does not legally own them so if they are sued, those assets won't be available to creditors or a bankruptcy trustee.

While a well-drafted asset protection plan can go a long way in deterring a creditor from pursuing sometimes expensive litigation (due to the risk of ending up with an empty judgment), the *Bankruptcy Act 1966* provisions impede those who desire to transfer or dispose of assets in the period leading up to the bankruptcy. Recognising that the Bankruptcy Act has evolved over literally hundreds of years, means slipping out of its traps is not easy.

TIMING

6 months (execution) and 20 business days (security in force) to register a security interest on PPSR.

When planning for asset protection it is obviously important to remember:

- There is no perfect asset protection structure, it is a matter of balancing priorities and determining what is most important.
- Asset protection planning evolves and therefore needs constant review.
- Asset structuring is far more effective if planned well in advance.
- Financial problems must be addressed proactively, and proceed on the basis that anything that has been done, in hindsight, can be undone.
- A complete asset protection strategy must consider not only business risk (and holding appropriate insurance cover to mitigate those risks), but also Family Law, Business Succession Planning, and Estate Planning.

Worrells created a comprehensive Asset Risk Exposure Checklist to provide guidance on the risks faced by those in business. While not exhaustive and without considering specific circumstances unique to each individual or the need to obtain professional advice, it helps to identify:

- Some key risks and exposures faced by those involved in a business enterprise.
- Whether your clients are exposed, and identify areas which may need to be managed.

To download our Asset Risk Exposure Checklist, click here.

DOWNLOAD

What is it?

The *Personal Property Securities Act 2009* (PPSA) replaced Commonwealth, state and territory based legislation with respect to parties' rights over personal property. The PPSA also established the Personal Property Securities Register (PPSR), again replacing existing registers, to be a single notice board of all registered interests in personal property. The PPSA commenced on 30 January 2012. The Australian Financial Security Authority (AFSA) administers the PPSR.

WHAT IS PERSONAL PROPERTY?

The term 'personal property' covers most examples of property dealt with in the normal course of a person's or company's business. Examples include: motor vehicles, boats, caravans and trailers, artwork, crops, inventory (stock), livestock, plant and machinery, shares, investment instruments, and intellectual property.

WHAT ASSETS ARE NOT COVERED BY THE PPSA?

Real property (including water rights and fixtures to real property) are not covered by the PPSA, and remain subject to existing state and territory based registrations.

HOW DO I OBTAIN SECURITY?

The most important element is there must be a signed security agreement between the parties. This must happen before the supply of any finance, or goods. Once a security agreement is signed, a registration should be made on the PPSR.

WHAT ARE THE TYPES OF REGISTRATIONS?

The two common types of registrations are identified as All Present and After-Acquired Property (ALLPAAP) and Purchase Money Security Interests (PMSI).

An ALLPAAP is a registration over all present and future property. Financiers for company finance, generally make an ALLPAAP registration when there is no specific purpose, e.g. an overdraft, loan, etc.

A PMSI is a specific registration for an interest in a specific item for all or part of its purchase price. A PMSI holder has a super priority, even over and above a security registered as an ALLPAAP. A PMSI is commonly registered by suppliers or financiers of; stock, motor vehicles, and items of plant and equipment.

WHEN DOES A SECURITY INTEREST HAVE TO BE REGISTERED?

A security interest must be registered within six months of execution, and 20 business days after the security interest came into force. If these periods are not met, there is a risk the security interest will not be enforceable against an external administrator or bankruptcy trustee.

A PMSI must be registered before the supply of the goods, if they are inventory (stock). For goods other than inventory (stock), the PMSI must be registered within 15 days after delivery of the item.

WHAT HAPPENS IF YOU DON'T REGISTER YOUR SECURITY INTEREST?

When an external administrator (liquidator or voluntary administrator) or a bankruptcy trustee is appointed, and where the security interest has not been properly registered or in time, the property will not be available to the creditor, but instead will be an asset of the entity who granted the security interest.

Therefore it is critical that suppliers and financiers properly register their security interests, and in time, to ensure they retain their rights to the assets in the event of default, or the appointment of an external administrator or bankruptcy trustee.

PPSA & VOLUNTARY ADMINISTRATIONS

Section 440B of the *Corporations Act 2001* imposes restrictions when a voluntary administrator is appointed to the company under Part 5.3A:

MORE INFO:
VOLUNTARY ADMINISTRATION P18

- An owner of property used by the company from taking possession of, or recovering, the property.
- A lessor from levying distress rent, taking possession, or otherwise recovering the property.
- A secured party with possessory security from selling the property or otherwise enforcing the security interest.

The voluntary administrator may still sell or dispose of assets:

- with the consent of the secured party
- with the consent of the court
- in the ordinary course of business.

Any asset disposal requires the voluntary administrator to distribute the sale proceeds from the secured property to those holding relevant security interests.

PPSA & DEEDS OF COMPANY ARRANGEMENT

A Deed of Company Arrangement (DOCA) cannot bind a secured party from enforcing or otherwise dealing with their security unless the DOCA makes a specific provision for their debt and they vote in favour of the DOCA.

MORE INFO:
DOCA P26

PPSA & LIQUIDATION

The stay of claims by creditors against the company and its property contained under sections 471B and 500 of the Corporations Act do not affect creditors with an enforceable security interest over assets of the company.

The property of any unperfected security interest vests with the company in liquidation. A security interest will also vest in the company if the security interest is not registered by the secured party:

- Six months before the commencement of the relevant external administration or insolvency (the critical time); or
- 20 business days after the security agreement came into force, or the critical time, whichever time is earlier.

MORE INFO:
LIQUIDATION P8

NEW TERMINOLOGY

The PPSA introduced a range of new terms.

These include:

Grantor—the party providing the security.

Secured Party—the party receiving the security.

Collateral—the secured asset.

Attachment—the creation of security over the collateral for value.

Perfection—is a technical term particular to the PPSA.
The security interest being enforceable against third parties and 'is stronger than the mere attachment of their security interest'.

Circulating Asset—previously described as floating assets, being assets used or transferred in the ordinary course of business.

Non Circulating Asset—previously described as a fixed asset, and prohibited from dealing with, without the consent of the secured party.

Purchase Money Security Interest (PMSI)—a security interest taken in collateral to the extent that it secures all or part of the purchase price. A PMSI provides a 'super priority' over other forms of security and is typically used in the supply of stock or other non circulating assets.

HOW DO I FIND OUT MORE OR REGISTER AN INTEREST?

To find out more, or to register a security interest, go to www.ppsr.gov.au

MORE INFO:
PPSA P72

OUTCOMES

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Employee Entitlements

Fair Entitlements Guarantee Act 2012

On 5 December 2012, the *Fair Entitlements Guarantee Act 2012* (FEG) commenced, as a legislative scheme to replace the General Employee Entitlements and Redundancy Scheme (GEERS). FEG assists employees who have lost their job because their employer entered into liquidation or bankruptcy. FEG operates in relation to claims for unpaid employee entitlements for employer liquidations and bankruptcies that occur on, or after 5 December 2012. GEERS continues to operate for claims that occurred before 5 December 2012.

INTRODUCTION

Employees are usually the most affected creditor when their employer becomes insolvent. Their jobs are at risk and their outstanding entitlements may not be recovered, or that receiving payment (even under FEG) will take a long time. Unlike other creditors that largely have income from other sources, and may have a security or personal guarantee to support their debts. The *Corporations Act 2001* provides employees certain priorities in consideration of these conflicting positions. The FEG provisions, in some circumstances, also provide payments to employees.

Often the priorities are of no consequence as there are no assets to cover employee entitlements, so the Federal Government assists employees under FEG/GEERS when there is insufficient money to satisfy their entitlements.

FEG

FEG was set up to ensure that employees of insolvent employers are paid at least some of their entitlements.

The scheme is designed to cover the payment of outstanding wages, leave and redundancy payments on the insolvency of the employer. FEG specifically excludes payment of outstanding superannuation. It also excludes the entitlements of directors, or relatives of directors, and individuals defined as 'excluded employees' under section 556 of the Corporations Act.

THRESHOLDS

Excluded employee (related to director/s): Can receive $2,000 for wages and $1,500 for leave entitlements in priority to non-employee creditors.

The scheme provides assistance with the following employee entitlements:

1. Wages—up to 13 weeks of unpaid wages.
2. Accrued annual leave.
3. All long service leave.
4. Payment in lieu of notice (up to 5 weeks).
5. A limited amount of redundancy (where a legal entitlement exists)—up to 4 weeks per full year of service.

The employee must have been terminated because of the insolvency of the employer (liquidation or bankruptcy). Any employee terminated for other reasons, even if owed money at the time of an insolvency practitioner appointment, is not eligible to claim under FEG.

FEG decide whether an employee has a claim, and decide on the payment amount. Employees must show they are an employee, and not a contractor. FEG requires documents to support their claim such as, an employment contract or agreement and pay-slips detailing start dates and normal wages.

FEG's strict review process requires the insolvency practitioner to verify the employee's entitlement and relevant contracts or awards. FEG then verifies the claims and can result in sometimes significant adjustments (as records may differ) to employees' claims. Once FEG and the insolvency practitioner agree, the funds are released to the insolvency practitioner to distribute to employees.

FEG has its own 'excluded employee' classification, which is, in essence the same as the Corporations Act's classification. FEG does not pay excluded employees (relatives of a director under the Corporations Act), regardless of the limits set for excluded employees under the Corporations Act. An employee may have a claim against the company (subject to the limits) but if the company does not have the funds to pay these, FEG will not pay those entitlements.

WHO IS AN 'EMPLOYEE'?

It is important to determine exactly who is an employee. The relevant definition of employee in section 556 of the Corporations Act is:

Employee, in relation to a company, means a person:

(a) *who has been or is an employee of the company, whether remunerated by salary, wages, commission or otherwise; and*

(b) *whose employment by the company commenced before the relevant date.*

The *Bankruptcy Act 1966* does not define 'employee', but in effect is described in the same terms with a priority to: "amounts payable by way of allowance or reimbursement under a contract of employment or under an award or agreement regulating conditions of employment".

Usually it is easy to determine if a person is an employee or a contractor. As a general rule, services supplied by a company, partnership and trust are not regarded as been supplied by an employee. It is clear when the service is supplied under an ABN.

WHICH ACT APPLIES?

Whether the Bankruptcy Act or the Corporations Act applies depends upon the legal form of the employer—a company or an individual or partnership etc, as follows:

- If the employer is a company—the Corporations Act applies.
- If the employer is a natural person—or a business owned and run by a natural person—the Bankruptcy Act will apply.

These two Acts deal with employee entitlements differently, with different priorities to different amounts. To make a claim, employees must be certain of their employer's legal form. The insolvency practitioner should provide the appropriate proof of debt to employees to complete.

TIMING

GEERS applies to liquidations that commenced before 5 December 2012.

FEG applies to liquidations that commenced on, or after, 5 December 2012.

THE CORPORATIONS ACT

PRIORITIES

Employees are generally owed entitlements when a liquidator is appointed. Some entitlements will be outstanding wages that are owing immediately, but some may be leave payments that are not, in the usual course, payable. The Corporations Act deems all employee entitlements are payable when a liquidator is appointed, giving employees the right to claim for outstanding leave (annual/long service). These amounts then form part of the payments to employees. Section 556 of the Corporations Act gives priorities for dividends to company employees. Employees are entitled to be paid their full entitlements, before other unsecured creditors. For a comprehensive understanding of the priority provisions, section 556 should be read in full.

In summary, priorities are in the order of:

1. Wages, superannuation contributions, and any superannuation guarantee charge.
2. Leave entitlements.
3. Retrenchment payments.

One of the differences between the two Acts are the Corporations Act requires employee entitlements to be paid in full before any other creditor is paid (subject to any circulating creditor claims under section 561). The Bankruptcy Act sets limits on the amount of priority given to employees.

Each separate employee entitlement is a separate class and forms a separate priority to be paid in that particular order. Each class of entitlement must be paid in full before the next class of entitlement may be paid (i.e. wages must be paid in full before any leave entitlements are paid). All priority employee entitlements must be paid in full before unsecured creditors receive a dividend.

EXCLUDED EMPLOYEES

The Corporations Act defines excluded employees as officers of the company, and their relatives. Although they are employees and have access to the priorities, for some entitlements, they have a statutory limit on the priority amount. For the entitlements not covered by the Corporations Act, these amounts become non-priority debt that are claimed alongside other unsecured creditors.

Currently, excluded employees can claim $2,000 for wages/superannuation and $1,500 for leave entitlements. Also, they can claim a retrenchment entitlement, but only for the amount attributed to when they were not excluded employees. In practice, this means that relatives of directors are unable to claim retrenchment compensation, unless their status changed during their employment.

The Bankruptcy Act does not have similar provisions, for employees related to the bankrupt.

CARRYING FORWARD OF EMPLOYEE ENTITLEMENTS

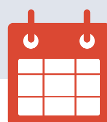
The liquidator may continue to trade the business and therefore retain the employees. A trade-on can be for days, or for months. Holiday, long service, and retrenchment entitlements are based on the length of employment. These entitlements are factored into the administration costs, and not as a distribution and is a cost payable under section 556(1)(a) of the Corporations Act.

The liquidator will determine what amount of the entitlement relates to the period of employment and pay that amount before declaring a dividend.

PAYMENTS TO EMPLOYEES BY THIRD PARTIES

Section 560 of the Corporations Act identifies that when a third party advances funds to a company to pay its wages and other employee entitlements they can 'stand in the shoes' of the employees. Thereby receiving the same priority that employees would receive if those payments were not made, but only to the amount they advanced.

THRESHOLDS



Non-excluded employee: No limit. Can receive their full entitlements.

SECURED CREDITORS

When secured creditors exercise their securities, they can generally bypass the insolvency process. However, the Corporations Act allows priority to employees, over assets subject to securities in either a liquidation or receivership scenario.

These provisions relate only to recoveries made from the realisation of circulating assets of a PPSA security (debtors and stock-in-trade etc.). Recoveries from non-circulating assets will not be affected by this section. They will be available in full to the secured creditor.

MORE INFO:
PPSA P72

Assets secured by a circulating security may be affected. Section 560 grants a priority to employees over those floating assets to the amount sufficient to pay wages and superannuation, leave entitlements, and redundancy entitlements to employees—or to a third party that received priority.

Section 560 gives the liquidator power to use floating assets to satisfy employees' claims. Secured creditors will not be paid from circulating assets until the liquidator has retained sufficient funds to pay these entitlements.

Receivers and managers are also bound by the same type of priorities in Part 5.2 of the Corporations Act. There are occasions when a receiver is acting but no liquidator has been appointed. If a controller is appointed before a liquidator, the Act obligates the controller to pay these entitlements.

The controller's priorities and limits are different to a liquidator's. The controller provisions do not include section 558 that activates all leave entitlements. Controllers only pay leave entitlements that are approved and due for payment at the time of their appointment. If the leave amounts are not approved by the company for payment before the appointment, they are not under the controller's priority.

The result of these two sections is that some employee entitlements will have priority over the secured creditor regardless of which insolvency practitioner is appointed. The balance of entitlements can be paid by a liquidator from any assets not subject to a security, or any surplus.

The Bankruptcy Act does not have any provisions granting priority over secured creditors claims to assets.

THE BANKRUPTCY ACT

PRIORITIES

The Bankruptcy Act deals with employee claims differently to the Corporations Act, although they still provide employees with priorities over unsecured creditors.

In summary, the Bankruptcy Act sets the following priorities:

1. Wages, some superannuation or other amounts due with some exceptions—to a limited of $4,350. This amount is linked to CPI and current indexed amounts released by the Australian Financial Security Authority.
2. Injury compensation and has no limitation.
3. All types of leave entitlements with no limitation.

Any amount not covered by the limited priority provisions can be claimed as a non-priority claim alongside other non-priority unsecured creditors.

The Bankruptcy Act does not have an 'excluded employee' classification, so employees related to the bankrupt are treated the same as other employees. There are no special provisions for an employee entitlement to have priority over secured creditor claims on assets. A secured creditor is not concerned with employee entitlements.

PAYMENTS TO EMPLOYEES BY THIRD PARTIES

When a third party advances funds to a company to pay its wages and other employee entitlements, they have the right to be repaid. This third party can 'stand in the shoes' of the employees and thereby receive the same priority that employees would receive if those payments were not made, but only to the amount they advanced.

The third party can claim for any shortfall from the priority amount as a non-priority creditor—their rights are also limited to the statutory limit on wages. Importantly, the advancement must be made prior to bankruptcy, for the intended purpose.

CARRYING FORWARD OF EMPLOYEE ENTITLEMENTS

The trustee may continue to trade the business and therefore retain the employees. A trade-on can be for days, or for months. Holiday, long service, and retrenchment entitlements are based on the length of employment. These entitlements are factored into the administration costs, and not as a distribution and is a cost payable under section 109(1)(a) of the Bankruptcy Act.

The trustee will determine what amount of the entitlement relates to the period of employment and pay that amount before declaring a dividend.

SUPERANNUATION CLAIMS

Employers must remit employer superannuation contributions to relevant funds within 28 days after the end of each quarter. If an employer fails to remit, they must lodge a Superannuation Guarantee Statement (SGS) with the Australian Taxation Office (ATO). The ATO can make a default assessment if this statement is not lodged.

If the employer is subject to an insolvency administration, the ATO may lodge a proof of debt with the insolvency practitioner for the Superannuation Guarantee Shortfall (assessment, default or otherwise). The SGS, which makes up the Superannuation Guarantee Charge (SGC), can be made up of three components:

1. the superannuation amount unremitted
2. a penalty
3. interest.

WHO CAN PROVE FOR UNPAID SUPERANNUATION?

The employer must deduct an amount for superannuation and pay to the employee's superannuation fund. The statutory superannuation amount is not technically a debt to the employee, and is not provable by the employee if it falls under a claim made by the ATO under the Superannuation Guarantee provisions (see below). Also, technically it is not a debt due to the superannuation fund trustee.

Section 553AB of the Corporations Act provides priority to the ATO's proof of debt over an employee's or superannuation fund trustee's proof of debt.

An employee can lodge a proof of debt for superannuation in the limited cases following:

1. Where the employer contributions are payable under a contract of employment, rather than an award or pursuant to the Superannuation Guarantee Levy.
2. Where the claim is for unremitted employee contributions (as opposed to employer contributions) under a salary sacrifice arrangement.
3. Where the outstanding superannuation contribution, for whatever reason (catch-all for other possible scenarios) does not form part of a SGC lodged by the ATO.

The Corporations Act, states that only the ATO can lodge a proof of debt for unpaid superannuation if it falls under the Superannuation Guarantee Charge—whether a claim has been made, or not. When the ATO has the right to make a claim for the SGS, no one else can make that claim.

SUPERANNUATION GUARANTEE SHORTFALL

The rules differ slightly under the Corporations Act and the Bankruptcy Act when it comes to the priority of the Superannuation Guarantee debt, or any claim that may be made by the employee or their superannuation fund trustee.

Under the Corporations Act any superannuation not remitted (contributions or superannuation guarantee charge) has a priority under section 556(1)(e), with superannuation specifically noted as a priority entitlement.

The superannuation amount is subject to the limit for excluded employees under section 556 (1A) of the Corporations Act. Previously it was determined that superannuation claimed is a claim payable to the ATO, not as an employee entitlement (payable to the employee), and not subject to the limitation—therefore claims related to excluded employees could be paid in full. This position changed on 1 January 2008 with a change in the wording of the legislation in section 556(1E) of the Corporations Act.

The Bankruptcy Act gives priority for amounts due to the bankrupt's employees. Section 109(1C) includes any outstanding SGC (which includes interest and penalties) as part of that priority amount.

Therefore, any superannuation amount claimed and proved for by the ATO is subject to the upper priority limit imposed by the Bankruptcy Act. The balance of superannuation guarantee charge would then be a non-priority debt along with the balance of the wages amount.

Claims by employees for excess contributions or contract contributions have the section 109 priority, as they are due in respect of an employee and for services rendered, but are also subject to that limited priority.

Dividends

Introduction

Dividends are the conclusion to most external administrations. Winding up a company cannot be finalised until dividends are distributed in accordance with statutory time limits and investigations to admit or reject proofs of debt are completed.

The *Corporations Act 2001* sets the minimum period to pay a dividend. If there are no complications, a corporate insolvency dividend will take about one month to distribute.

If there is a complexity in relation to the admissibility of proofs of debt, the payment of the dividend can be delayed, particularly if a creditor applies to the court for a review of the liquidator's decision to reject their proof of debt.

DIVIDENDS IN DETAIL

When there are funds to distribute, the payment of a dividend is often the only tangible output from a winding up.

A liquidator withholds sufficient monies to complete the winding up. They also determine the most appropriate time to pay dividends when considering any further anticipated realisations and the costs related to paying a dividend.

Dividends must be declared in accordance with the requirements of the Corporations Act, and be paid to creditors in order of their priority.

STEPS IN PAYING DIVIDENDS

The four basic steps required to pay dividends are:

1. call for proofs of debt—every known creditor must have the opportunity to lodge a proof of debt and participate in the dividend
2. admit proofs of debt—verify that the debt is proper and has been 'proved' to the liquidator's satisfaction
3. reject proofs of debt—to ensure only legitimate creditors participate in the dividend
4. pay the dividend—the liquidator distributes the cheques.

1. CALL FOR PROOFS OF DEBT

All creditors must be given the opportunity to lodge their claim in the form of a proof of debt. A proof of debt is a formal document used to prove that a debt exists and it sets out the amount of the debt. Without sufficient proof that the debt exists, it will not be admitted for the stated amount or possibly it may not be admitted at all.

Proofs of debt are a prescribed form under the Corporations Act. A liquidator may not admit claims that are insufficiently detailed on the correct form, which may result in a creditor being excluded from a dividend.

Creditors can lodge proofs of debt at any stage in an administration. They do not need to wait until a dividend is called, and only need to submit one. Creditors should ensure that their claim has been lodged and appears in any list of proofs of debt received. If creditors are in any doubt that their claim has been lodged, they should contact the liquidator's office.

THRESHOLDS

Minimum dividend: Liquidators are not required to pay a dividend under $25.00 to any creditor.

Periods for calling for proofs of debt

The liquidator must formally notify all known, or potential, creditors of the intended dividend and request that proofs of debt be lodged by a certain time.

The Corporations Act states that creditors must be given at least 21 days to lodge proofs of debt.

Definite periods to lodge proofs of debt are important to expedite dividend payments or to ensure dividends are not challenged while cheques are being drawn. The cut-off date for proofs of debt is final and the provisions of the Corporations Act set out the creditors' and liquidator's rights if a proof of debt is not lodged in time.

Notices to be issued for calling for proofs of debt

To notify creditors in accordance with the Corporations Act, two notices must be issued:

1. an advertisement on ASIC's website to notify the public
2. a Corporations Form 547 or 548 must be posted to creditors that have not lodged a proof of debt.

Dates for payment of dividends

Dividends cannot be paid until the proofs of debt cut-off date has passed and all proofs of debt have been admitted or rejected. That is, cheques will not be drawn within that period.

The notice period from the initial notice calling for proofs of debt to the intended payment date must not be longer than two months. However, payment may be made after the intended payment date due to complications in the dividend process, typically due to the admittance and rejection process.

If the dividend date is postponed, the liquidator may need to re-advertise the notice with a new intended date.

$29 Nationally, Worrells distributed to creditors over: million in dividends

$29,862,553

to be exact—in 2015/16.

Non-lodgement of proof of debt

Creditors that miss the proof of debt cut-off date can lodge a proof of debt for the next dividend distribution, and they will be paid the first dividend they missed out on (a catch-up dividend), as well as the upcoming dividend. If there are insufficient funds to pay a second dividend (a second dividend is never declared), creditors will not receive a dividend at all. Therefore, it is imperative that creditors lodge their proofs of debt before the cut-off date.

2. ADMITTING PROOFS OF DEBT

Creditors have the burden to prove the existence and amount of their debt. The liquidator does not need to disprove a debt.

The liquidator assesses the creditors' supporting evidence and determines the validity and amount of the debt. If the liquidator believes that all or part of the debt is not sufficient, they will seek further clarification and material from the creditor. Without further information, the liquidator may reject the proof of debt in full or in part. The liquidator is not required to locate sufficient information.

Creditors should attach copies (not originals) of all appropriate documents to their proof of debt.

Liquidators must review proofs of debt within 14 days of the lodgement date and decide to admit or reject the claim or seek further information. The Australian Securities and Investments Commission (ASIC) can grant an extension to the review period.

On average, these dividends work out to be:

$2,488,546 in dividends each month

$124,427 in dividends per business day

Liquidators must review proofs of debt within 14 days of the lodgement date and decide to admit or reject the claim or seek further information.

3. REJECTING PROOFS OF DEBT

If a proof of debt is rejected because a creditor does not provide sufficient evidence, a liquidator will provide a notice outlining the reasons for rejecting the proof of debt and will set a deadline for appeal.

Appeals against decisions

Creditors' rights are set out in regulation 5.6.54 of the Corporations Regulation. Creditors can have the court review the liquidator's decision to reject their proof of debt, but have a limited time to apply for adjudication. A liquidator can amend their decision to reject a proof of debt when sufficient information is given if it is still within the required timeframe.

The court may allow an application for adjudication after the time limit period expires, but creditors should not rely on it being granted.

Creditors have the burden to prove to the court that the claim should be admitted in the liquidation. Creditors must show that the decision to reject the proof of debt was incorrect based on the information provided to the liquidator.

Revoking a decision to admit or reject

A liquidator can reverse their admittance or rejection of a proof of debt.

When a liquidator reverses their initial decision to reject a proof of debt, they must give the affected creditor notice of the new decision and, if appropriate, adjust the dividend to be paid or, if necessary pay a catch-up dividend.

4. PAY THE DIVIDENDS

Dividends are paid after the proof of debt lodgement date expires, after all the proofs of debt have all been admitted or rejected, and after any appeals on rejections have been heard in court. The liquidator will forward a cheque to the creditor.

If dividend cheques are not banked within a reasonable period, or if creditors cannot be located, the liquidator will hold monies for six months following payment, and then forwarded these monies to ASIC. The creditor must then request the money from ASIC.

Priorities in the payment of dividends

Subject to specific priorities, all creditors will rank equally in a winding up and will be paid 'pro-rata' dividends.

The Corporations Act gives the greatest priority to employees. Entitlements due to employees must be paid in full before payments to non-priority creditors.

TIMING

Notice for creditors to lodge proofs of debt: At least 21 days before declaration.

Minimum time after declaration before payment of dividend: No time limit. The dividend may be paid immediately after the end of the lodgement period.

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