INSOLVENCY LAW SUMMARY 2011

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1. Overview and Theory

1.1 The Insolvency Process

- Insolvency is concerned with a process:
  - Appointment
    - What type of appointment has been made?
      - Receivership, voluntary administration, liquidator (what type of "insolvency practitioner")?
    - Has this appointment been validly made?
  - Investigation

        - What is the effect of the appointment in relation to the powers of the insolvency practitioner?
        - Has the directors engaged in insolvent trading or entered into voidable transactions?
    - Meeting / Priorities / Payments
        - Who are the creditors?
        - Has there been a valid meeting?

- Hence, in problem questions, the following questions need to be asked:
    - What type of appointment has occurred?
    - What is the stage of the insolvency process?

1.2 Insolvency Theory

1.2.1 The "Creditors Bargain" Model

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- Basic corporate law theory is primarily influenced by the shareholder primacy norm whereby the board of directors is accountable to the shareholders because the shareholders are the primary risk-bearers. However, where the company becomes insolvent, the shareholder primacy norm becomes redundant and the "creditors bargain" model becomes relevant.
- The creditors bargain model is based on the notion that insolvency is a fact as opposed to an issue of morality. It asserts that there should be a stay of proceedings amongst the creditors of an insolvent company in order to preserve the pool of assets so that there can be an equitable distribution amongst the creditors (the 'pari passu' principle). Where there are secured (hold rights in rem) and unsecured creditors (hold rights in personam), this model enables recognition of these priorities such that secured creditors are paid out before unsecured creditors.

1.2.2 Distributional Theory

- The disadvantages associated with the creditors bargain model comes to fruition when consideration is given to employees and tort claimants who may become potential creditors of an insolvent company. Moreover, such creditors have limited bargaining power in relation to obtaining a secured charge over the company and, hence, the creditors bargain model operates to their disadvantage. In recognition of this disadvantage, distributional theories have emerged which assert that insolvency is a social problem and should be treated accordingly. Furthermore, insolvency is an opportunity to redistribute wealth amongst society such that employees and tort claimants should be given priority over secured creditors.

1.2.3 Australian Law

- Australian insolvency law is a combination of these theories.

- There has been a recent push by the ACTU to encourage the Rudd Government to pass legislation which penalises directors of insolvent companies who do not have enough assets to pay out employees' entitlements. Should such legislation be enacted it would reflect the distributional theory.

2. Assessing Solvency

2.1 Test for Assessing Solvency

- Section 95A(1) provides that a person (individual or company) is solvent where they can pay their debts as and when they become due and payable. Where a person does not have this ability they are insolvent (s 95A(2)).

- The provision imports the "cash flow" test (does the company have sufficient cash or realisable assets to pay their creditors when payment is demanded?) as opposed to the "balance sheet" test (does the company's total assets outweigh their total liabilities?) (*Crema Pty Ltd v Land Mark Property Developments Pty Ltd*). However, this test is not strictly applied because there is a need to distinguish between a temporary lack of liquidity (in which case the company is solvent) from an endemic shortage of working capital (in which case the company is insolvent) (*Hymix Concrete Pty Ltd v Garrity*).

- The elements can be broken down as such:

  - an ability (or practical capacity) to pay;

  - their debts (as distinct from claims);

  - as and when they become due and payable.

2.2 Cases Interpreting Section 95A

2.2.1 The Test

- *Southern Cross Interiors Pty Ltd v DCT*

  - The question of whether a company is solvent or insolvent is a question of fact to be determined according to the company's financial position as a whole.

  - In considering the company's financial position, regard must be had to commercial realities in ascertaining:

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- the company's available resources;
- the company's potential for acquiring resources by liquidating assets or acquiring loans; and
- when such realisation of assets is achievable.

2.2.2 Indicators of Insolvency

- In *Lewis v Doran*, Justice Palmer outlined the indicators of insolvency including:
    - whether there is a history of dishonouring cheques;
    - whether suppliers have provided goods on a COD basis;
    - whether the debtor company has issued post-dated or "rounded-sum" cheques;
    - whether the debtor company has made special arrangements with creditors;
    - whether the debtor company can produce timely, audited accounts;
    - whether the debtor company has unpaid group tax, payroll tax, workers compensation premiums or superannuation contributions;
    - whether the company has received demands from bankers to reduce its overdraft limits; and
    - whether the company has received statutory demands or letters of demand from creditors.

2.2.3 Ability to Pay

- The first element contained in s 95A concerns the ability of the person to pay their debts or their practical capacity to pay their debts. This ability is not limited to their cash reserves but also to assets which can be realised within a relatively short period of time.
- *Sandell v Porter*
    - The ability or practical capacity of the person to pay their debts is not limited to their cash reserves but also to assets which can be realised within a relatively short period of time.
    - Whether a period of time will suffice this test depends on the nature and amount of the debt and the circumstances of the debtor's business.

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- *Lewis v Doran*
  - Facts
    - There was a corporate group restructure whereby a subsidiary company (Constructions) was confronted with substantial claims for breach of contract.
    - The issue was whether Constructions was insolvent at the date of this restructure and, more importantly, whether the court could take into account the ability of Constructions to obtain an unsecured loan from the parent company (Holdings) to pay their debts.
  - Held
    - The omission of "debtor's own monies" from the definition of solvency in s 95A of the *Corporations Act* has the effect that the court can have regard to commercial realities when determining insolvency.
    - In a case of retrospective insolvency, the court can take into account the fact that as at and after the alleged date of insolvency the company continued to pay its debts through an unsecured loan by a related third party (holding company or company director).
    - In a case of prospective insolvency, the court is more reluctant to accept that a third party will advance funds to prevent the company from becoming insolvent. Whether this factor will support the company's solvency will depend upon the willingness of the third party which must be cogently demonstrated.
    - Section 95A requires the court to determine whether the company is able to pay all their debts by reference to commercial realities. Where the court is satisfied that as a matter of commercial reality the company has resources available to pay its debts, it is immaterial whether the resource is an unsecured loan or a voluntary extension of credit by a third party.
- *ASIC v Edwards*
  - A court will not take into account the ability to borrow for the purposes of a solvency assessment where it amounts to the company replacing a debt with a new debt.
- *Hall v Poolman*

SAMPLE ONLY

- In considering whether a company has the practical capacity to pay its debts by realising assets, the rule of thumb is that the assets must be capable of realisation within 90 days.

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