


Baker McKenzie.

OVERVIEW OF AUSTRALIAN CORPORATE INSOLVENCY REGIMES

Restructuring & Insolvency

Overview of Australian Corporate Insolvency Regimes

This document provides a summary of the most common Australian formal corporate insolvency regimes, namely:

- voluntary administration;
- receivership; and
- winding up.

It also covers creditors' schemes of arrangement which are increasingly being used in larger restructurings.

Some other types of formal insolvency regimes that are less common are not covered and are beyond the scope of this document, for example, provisional liquidation and informal insolvency mechanics, such as workouts.

Australian corporate insolvency law is Commonwealth, not State based, and is governed by various statutory instruments, including the *Corporations Act 2001* (Cth) **(Corporations Act)**, the *Insolvency Practice Schedule (Corporations)* a schedule to the Corporations Act, the *Corporations Regulations 2001* (Cth) **(Corporations Regulations)** and the *Insolvency Practice Rules (Corporations) 2016* (Cth) **(Insolvency Practice Rules)**. All statutory references in this document are to the Corporations Act unless stated otherwise.

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Voluntary administration

Overview

The voluntary administration procedure in the Corporations Act was introduced in 1993. Prior to this, the only formal mechanism for a company to compromise with its creditors was by a creditors' scheme of arrangement, a process often regarded as costly, time consuming and cumbersome.

The voluntary administration process gives a company a short breathing space, during which there is a general moratorium on the enforcement of creditors' claims.

The primary objective of voluntary administration is to provide for the business, property and affairs of an insolvent company to be administered in a way that:

- maximises the chances of the company, or as much as possible of its business, continuing in existence; or
- if it is not possible for the company or its business to continue in existence – results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

The voluntary administration process gives a company a short breathing space, during which there is a general moratorium on the enforcement of creditors' claims. It enables the administrator to continue to trade the company's business during the administration period, and for any proposal to rehabilitate the company or otherwise maximise returns to creditors (other than via an immediate winding up) to be put before creditors and, if approved, implemented via a deed of company arrangement **(DOCA)**. A DOCA will be binding on key stakeholders including the company, its shareholders and its creditors (save for secured creditors who do not vote in favour of the DOCA).

The voluntary administration process is intended to be quick, although in more complex administrations (such as corporate groups) it is usual for the Court to extend relevant time limits and the administration period may extend for over a year. Extensions are allowed by the Court on a case by case basis and are entirely dependent on the circumstances of the particular administration.

In addition to providing a mechanism to maximise returns to creditors by allowing a distressed company to trade on, the voluntary administration procedure has other benefits including that:

- it is fast to implement by a simple resolution of the company's board of directors;
- it requires no Court involvement;
- the appointment of an administrator effectively avoids insolvent trading liability for the directors of the company in respect of the period post-appointment; and
- the voluntary administration procedure imposes a moratorium in respect of various claims against the company and property in its possession during the period of the voluntary administration.

Comparison to US Chapter 11

Australia's voluntary administration procedure has the same aim of corporate rehabilitation as the US Chapter 11 process, but has some important differences including that:

- the company's directors are deprived of any power during the administration period and the administration is conducted by an independent insolvency practitioner who must be a registered liquidator (and so, voluntary administration is not a debtor in possession process);
- a voluntary administration can take place entirely without Court involvement (and any Court involvement will usually be limited); and
- a secured creditor with a security interest over the whole or substantially the whole of the property of the company is entitled to enforce that security within 13 business days after the appointment of the administrator (or such longer time as the Court may order or the administrator may agree).

Commencement of voluntary administration

A voluntary administration is usually commenced by the directors of a company resolving that, in their opinion, the company is insolvent or is likely to become insolvent in the future and that an administrator should be appointed.

Although less common, a secured creditor who is entitled to enforce a security interest over the whole or substantially the whole of the property of the company or a liquidator of the company may also appoint an administrator in certain circumstances.

The consent of the proposed administrator must be obtained before the appointment is effective. The administrator must be a registered liquidator with the Australian Securities and Investments Commission **(ASIC)** and must not be disqualified from accepting the appointment under the Corporations Act.

It is normal to have two or more administrators appointed jointly and severally, to ensure appropriate continuity in the event of absence or ill health.

Role and powers of the voluntary administrator

The administrator takes control of the affairs and business of the company, and acts as agent of the company. An administrator is a fiduciary and, as an officer of the company, is subject to the duties applicable to company officers.

The administrator has very broad powers including to trade on the company and sell its assets. The administrator is not subject to an equivalent of the strict section 420A of the Corporations Act obligation that applies to a receiver in realising company assets (as discussed below).

Importantly, the administrator is personally liable for debts of the company incurred during the administration period for services rendered, goods bought, property leased or occupied and funds borrowed. This personal liability is intended to encourage suppliers, employees and customers to continue to trade with the company during the voluntary administration period. It does not extend to pre-appointment liabilities of the company. The personal liability means that an administrator will be reluctant to trade on (including to retain employees or cause the company to perform contracts) where there are not available funds to do so or where this would prejudice the position of creditors.

The administrator has a right of indemnity out of the property of the company for debts or liabilities incurred by the administrator and for the administrator's remuneration. This right of indemnity takes priority over unsecured debts of the company, and also over any debts secured by any circulating security interest - broadly equivalent to assets which were previously the subject of floating charges, and including cash, receivables, inventory and similar assets - at least until the secured creditor enforces their security (to the extent that they are able to do so consistently with the statutory moratorium discussed below), such as by the appointment of a receiver.

Impact of a voluntary administration

The powers of the company's officers are suspended during the administration period. However, they are required to assist the administrator in his or her investigation into the company's affairs. Some company management may be retained by the administrator for continuity but they are required to discharge their duties and perform their functions subject to the direction of the administrator.

Generally, only the administrator can deal with the property of the company during the administration period.

A transfer of shares in a company, or an alteration of the status of its shareholders, after the commencement of an administration is void unless done with the consent of the administrator or pursuant to an order of the Court.

The appointment of an administrator does not, of itself, constitute a repudiation of contracts to which the company is a party. Akin to the US position, and as a result of the ipso facto reforms to the Corporations Act which became effective from 1 July 2018, there is now a general prohibition in administration on counterparties relying on ipso facto clauses to terminate for an insolvency event of default (subject to a range of exclusions).

Although the administrator does not have formal power to disclaim contracts as a liquidator does, the administrator may repudiate contracts requiring performance by the company, as is likely where the administrator is not trading on some or all of the business (such as where he or she does not have funds to do so). This leaves counterparties to pursue their entitlement to damages for breach of contract by way of proof of debt in any subsequent creditors' voluntary winding up or deed of company arrangement.

The company also has the benefit of a statutory moratorium during the administration period, discussed under the following heading.

The moratorium

During the administration period:

- creditors, including some secured creditors, are prohibited from taking any action against the company to recover debts, enforce security interests or have the company wound up; and
- owners or lessors of property that is being used by or is in the possession of the company - including leased premises and goods subject to retention of title or Purchase Money Security Interest **(PMSI)**[1] terms - are prohibited from seizing or reclaiming property (notwithstanding that they may have contractual rights to do so);

"Owners or lessors of property that is being used by or is in the possession of the company...are prohibited from seizing or reclaiming property (notwithstanding that they may have contractual rights to do so)"

in each case without the consent of the administrator or order of the Court. As discussed above, the administrator has personal liability in respect of services rendered, goods bought, property leased or occupied and funds borrowed during the administration.

The main exceptions to the moratorium are:

- in relation to perishable goods;
- where enforcement has commenced prior to the appointment of the administrator; or
- where a secured creditor who has a security interest over the whole or substantially the whole of the company's property (which, where relevant, has been perfected under the *Personal Property Securities Act 2009* (Cth)) enforces their security interest within the "decision period", being 13 business days from the giving of notice by the administrator of their appointment or from the commencement of the administration, or such further time as may be permitted by order of the Court or consent of the administrator.

The administrator is not able to deal with property subject to a security interest (including property the subject of retention of title or PMSI terms) unless in the ordinary course of business, or with the consent of the secured creditor/owner or the leave of the Court.

Where retention of title or PMSI property is used by the administrator in the ordinary course of business, the Corporations Act requires the administrator to act reasonably in exercising any rights to dispose of that property and to apply the proceeds of sale in a particular manner according to the statutory priority of interests in that property.

In addition, guarantees granted by directors of the company cannot be enforced during the administration period.

Meetings of creditors in a voluntary administration

There are two meetings of creditors required to be held in a voluntary administration.

The first meeting of creditors must be convened immediately after the appointment of the administrator and be held within eight (8) business days of the appointment.

The only official business at the first meeting of creditors is to consider the possible replacement of the administrator (which rarely happens) and to determine whether creditors wish to appoint a committee of inspection and if so to appoint the committee. The real value of the first meeting is in meeting the administrator,

1 as defined in the *Personal Property Securities Act 2009* (Cth).

asking questions, and obtaining information about the administration.

The second meeting of creditors is more substantive in terms of outcomes and must be convened either 5 business days before, or 5 business days after the end, of the convening period. The convening period for the administration operates for 20 business days from the date of the administrator's appointment[2] unless the convening period has been extended by the Court, which is common in larger and more complex administrations.

In convening the second meeting, the administrator must provide creditors with a report **(Report)** which:

- discusses the company's business, property, affairs and financial circumstances;
- sets out the details of any proposed DOCA to be put to creditors; and
- provides the administrator's opinion as to whether it is in the interests of the creditors for the company to execute any DOCA which has been proposed, for the administration to end (and the company be returned to the control of its directors) or for the company to be wound up, and the reasons for that opinion.

The Report will, where a DOCA is proposed, consider the likely returns to creditors in a winding up compared to the likely returns under the proposed DOCA, both as to quantum and likely timing. This will involve a consideration of what liquidator's recoveries may be available if the company is wound up, as these recoveries are not available in an administration or DOCA.

The second meeting of creditors may be adjourned by resolution of creditors for up to 45 business days, and potentially for longer by order of the Court.

For each meeting of creditors, the administrator will ask creditors to submit proofs of debt for voting purposes, and proxies (if the creditor is a corporation or an individual not attending the meeting in person). Creditors will be given a further opportunity to lodge a formal proof of debt at a later stage, if any dividend is to be paid

Voting in voluntary administration

There is no voting by separate class of creditors in voluntary administration, and voting is done on the basis that all creditors are effectively the one class.

Voting at meetings of creditors in administration is "on the voices" unless a poll is demanded (as is common).

If a poll is demanded, a resolution will only be passed if a simple majority of creditors present and voting is obtained by both value and number. If only one of these majorities is met, the administrator will exercise a casting vote. There is no requirement that the administrator's casting vote be exercised with the value vote or the number vote, and an administrator will generally exercise their vote in accordance with the recommendation they made to creditors as to what outcome was in their best interests in the Report.

Any exercise of a casting vote by the administrator, and the passing of (or the failure to pass) a resolution on the votes of related creditors can be challenged in Court.

A DOCA binds the company, its creditors, officers, shareholders and administrators, however, secured creditors can only be bound by a DOCA if they voted in favour of it.

Committee of inspection

A committee of creditors, called a committee of inspection, may be appointed at the first meeting of creditors in an administration. Essentially, the committee of inspection is available to consult with the administrator, such as on any proposal to seek an order to extend the convening period for the second meeting of creditors. Generally, the administrator will seek approval of his or her remuneration from the committee of inspection.

Outcome of voluntary administration

As noted above, prior to the second meeting of creditors, the administrator must investigate the financial situation and affairs of the company and recommend to the company's creditors in the Report whether it is in their interests to:

2 If an administrator is appointed close to Christmas or Easter, the convening period may run for 25 business days.

- end the administration and hand the company back into the control of its directors (which is uncommon and would only be appropriate if the company is solvent);
- have the company enter into a DOCA; or
- have the company wound up by transition to a creditors' voluntary winding up.

The administration usually ends when creditors resolve at the second meeting of creditors in favour of one of these options or, if the creditors resolve that the company enter into a DOCA, on its execution.

A deed of company arrangement or DOCA

A DOCA is a statutory contract between the company and its creditors that governs the relations between the company and its creditors after the end of the voluntary administration. The Corporations Act specifies certain minimum requirements of a DOCA including the nature and duration of any moratorium period, property available to pay creditors, the order of payments to creditors (usually in accordance with the statutory priorities applicable in a winding up) and the release of the debts of the company.

A DOCA is administered by a deed administrator who is usually (but is not necessarily) the same person who was appointed as the voluntary administrator of the company.

A DOCA may allow the company to trade on, including under the control of its directors, and will provide for a fund for distribution to creditors. Such a fund which will often be contributed by a third party (such as a director or shareholder), and be funds that would not be available for the benefit of creditors in a winding up of the company.

A DOCA must give employee entitlements the statutory priority to which they would be entitled in winding up out of assets of the company coming under the control of the deed administrator. Employee creditors may vote to modify this priority at a separate meeting of the employees convened under section 444DA of the Corporations Act. Priority employee entitlements include wages and superannuation, leave and redundancy entitlements.

The Australian Courts have held that a DOCA cannot effect a compromise of the claims of creditors of a company against third parties, such as the party or parties contributing to a deed fund available under the DOCA for distribution to creditors. This limitation has in part been responsible for the growing popularity in recent years of creditors' schemes of arrangement (discussed further below).

The DOCA does not affect the rights of future creditors of the company if it continues to trade and incur debts. If the DOCA is terminated because it has been fully effectuated, the company is returned to the control of its directors and the claims of creditors against the company are released as provided for in the DOCA.

However, if the DOCA is terminated prematurely, it is likely that the company will proceed into liquidation.

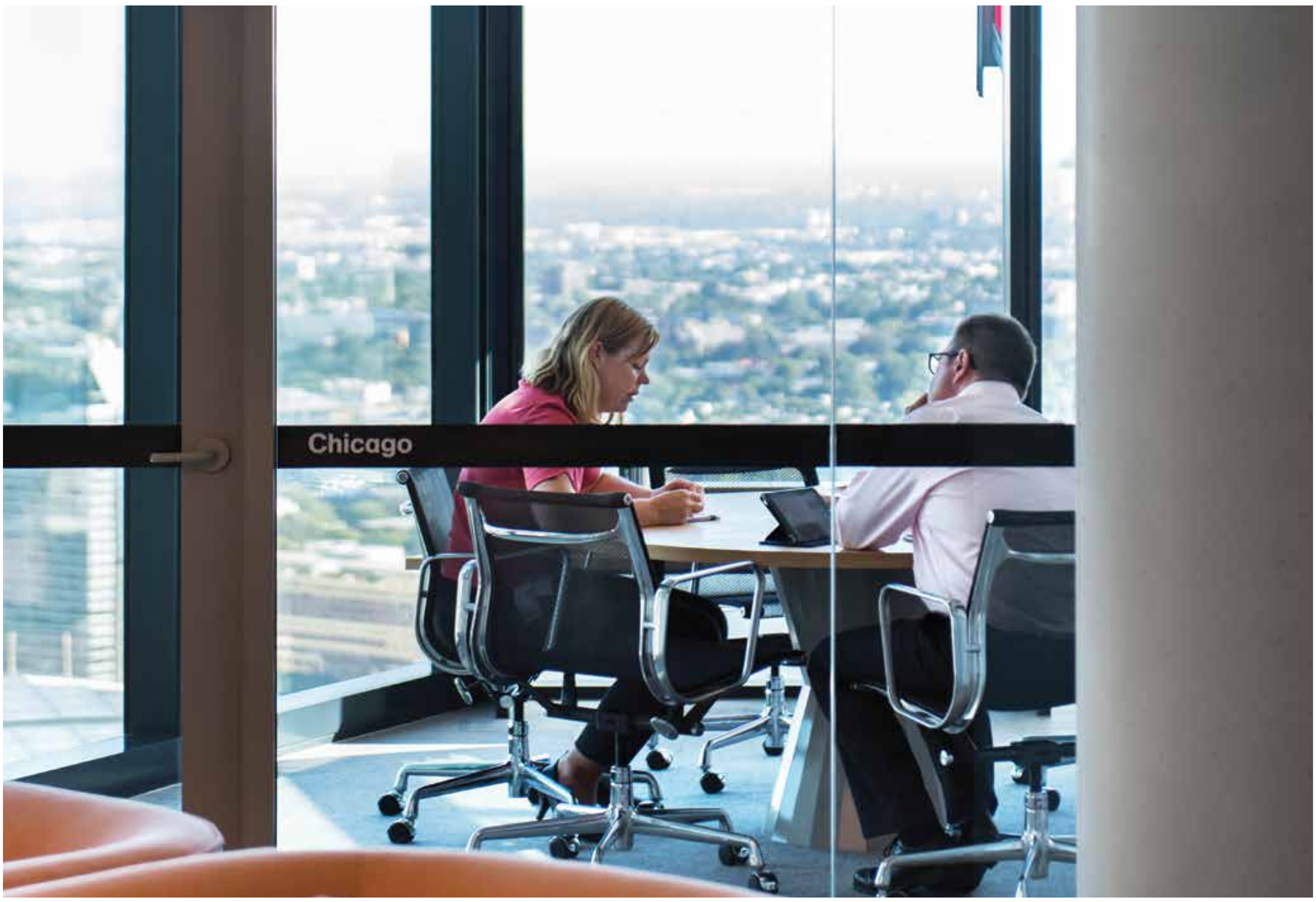
Additionally, the Corporations Act provides for a DOCA to be set aside on an application to the Court (in particular circumstances), and for a DOCA to be varied including by resolution of creditors.

The role of the Court in voluntary administration

The Court has no role in the appointment of a voluntary administrator.

While it is entirely possible that the Court will have no involvement in a voluntary administration, it is common for the Court to be asked to extend the period in which the second meeting of creditors must be convened on the application of the administrator. This extension is sometimes sought and granted on more than one occasion during a voluntary administration.

However, the Court has very broad powers to make orders in connection with administrations, and an administrator can seek directions from the Court and is subject to the supervision of the Court. Creditors and other persons aggrieved by an act, omission or decision of an administrator or a deed administrator (including the adjudication of their proof of debt) can appeal to the Court.



Creditors' schemes of arrangement

Overview

A creditors' scheme of arrangement is a compromise or arrangement between a company and its creditors (or some of them) effected pursuant to the process prescribed in Chapter 5.1 of the Corporations Act. This process requires:

- ASIC being provided with a draft of the scheme documents to be sent to affected creditors (colloquially referred to as a scheme booklet) at least 14 days in advance of the initial or first Court hearing;
- an initial or first Court hearing at which orders are made convening a meeting or meetings of the affected creditors and to seek approval of the material to be despatched to those creditors;
- a meeting or meetings of the affected creditors be held to vote on the proposed scheme of arrangement;
- a second Court hearing to approve the proposed scheme of arrangement, assuming it has been passed by the requisite majority at the meeting or meetings of creditors;
- the lodgment of the orders made at the second Court hearing with ASIC in order for the creditors' scheme of arrangement to become effective.

Generally, this process takes around three months to complete, assuming that the terms of the proposed scheme of arrangement have already been negotiated and agreed with key parties.

The above process can be, and often is, used to effect a members' scheme of arrangement, or a friendly takeover, discussion of which is beyond the scope of this paper.

In a creditors' scheme of arrangement, it will be necessary for the company to lead evidence to the effect that it will be solvent as a result of the compromise or arrangement to be effected by the scheme of arrangement.

Benefits of a creditors' scheme of arrangement compared to a DOCA

A creditors' scheme of arrangement is generally considered to be costly, time consuming and cumbersome, which is why the voluntary administration and DOCA processes are often more suitable. Unlike in an administration and DOCA, the Court is heavily involved in a creditors' scheme of arrangement, and ASIC also has a critical role.

However, creditors' schemes of arrangement have some benefits over DOCAs, and are increasingly being used in corporate insolvency and restructuring in Australia, including because:

- if a third party is contributing funds for the benefit of creditors, that third party can be effectively released from claims by those creditors via a creditors' scheme of arrangement but not via a DOCA;
- creditors' schemes of arrangement - which involve two separate Court hearings - generally cannot be set aside, unlike a DOCA, and so there is greater certainty as to their ultimate implementation;
- creditors' schemes of arrangement can be tailored to only compromise with a particular class of creditors, such as secured creditors. Other classes of creditors, such as trade creditors, can be left unaffected (and of course, those other creditors are not entitled to vote on the scheme of arrangement);
- any diminution of value caused by a creditors' scheme of arrangement is able to be better managed than in other types of formal insolvency. If a creditors' scheme of arrangement is done independently of any other

formal insolvency regime, the company essentially avoids any period of external control by an insolvency practitioner. As a restructured solvent outcome has been prearranged, stakeholders are able to be proactively managed and the perceived impact of the process is less damaging than with other forms of external administration. In addition, as a result of the *ipso facto* reforms to the Corporations Act which became effective from 1 July 2018, there is now a general prohibition in a creditors' scheme of arrangement to avoid an insolvent winding up on counterparties relying on *ipso facto* clauses to terminate for an insolvency event of default (subject to a range of exclusions).

Voting threshold on a creditors' scheme of arrangement

To approve a creditors' scheme of arrangement in each relevant class, a majority of creditors in the relevant class present and voting (either in person or by proxy) must vote in favour of the scheme at the relevant meeting. The majority which is required to approve the scheme must constitute creditors whose debts or claims against the company amount in the aggregate to at least 75% of the total amount of debts and claims of the creditors present and voting in person or by proxy in the relevant class.

Notwithstanding achievement of the necessary statutory majorities of creditors, the Court retains an overriding discretion as to whether or not to approve a creditors' scheme of arrangement. The Court will take into consideration issues of fairness in considering whether or not to approve a creditors' scheme of arrangement.

A creditors' scheme of arrangement binds all creditors in the affected classes which can include secured creditors.

Receivership

Overview

A receiver (often appointed as a receiver and manager) is the most common form of what is referred to as a controller in the Corporations Act. A controller can also include a mortgagee in possession or their agent.

A receiver is generally, privately appointed by a secured creditor over some or all of the property of the company that is subject to their security interest. The purpose is to realise the secured property and apply it in reduction of the secured debt.

A receiver may also be appointed by a Court. A discussion of Court appointed receivers is beyond the scope of this overview.

Commencement of receivership

A receiver is usually appointed to assets of a company by a secured creditor pursuant to a security agreement.

Procedurally, the appointment of a receiver is effected by the execution of a deed of appointment by the secured creditor and the proposed receiver, after any necessary procedural formalities arising from the underlying security agreement or applicable legislation have been complied with. It is also standard that the secured creditor will indemnify the receiver appointed for any liabilities of the receiver incurred during the course of the receivership. This indemnity is usually set out in a separate deed of indemnity.

A receiver must be a registered liquidator with ASIC. Additionally, there are a range of circumstances disqualifying a person from accepting an appointment as a receiver which are designed to ensure that receivers are appropriately independent.

It is normal to have two or more receivers appointed jointly and severally, to ensure appropriate continuity in the event of absence or ill health.

Role and powers of the receiver

The receiver's role is to realise enough of the company's assets which are subject to the security interest in order to discharge the outstanding debt owed to the secured creditor. Once the secured creditor has been paid in full or the secured assets have all been realised, the receivership terminates and control of company's property is returned to its directors unless the company is in another form of external administration.

The receiver has no direct role in relation to the unsecured creditors of the company, which is why it is common to have a receivership take place concurrently with an administration or liquidation (discussed further below).

The receiver is normally specified in the security and appointment documents to be the agent of the debtor company, rather than of the secured creditor, in undertaking his or her tasks. A receiver, as an officer of the company, is subject to the duties applicable to company officers.

A receiver must be a registered liquidator with ASIC. Additionally, there are a range of circumstances disqualifying a person from accepting an appointment as a receiver which are designed to ensure that receivers are appropriately independent.

The powers of receivers are set out in the appointment document and in the Corporations Act. These will generally be powers to manage, preserve and realise the company's assets for the benefit of the secured creditor. If the receiver is given the power to manage the affairs of the company, as is usual, the receiver will be referred to as a receiver and manager.

Impact of a receivership

Unlike in winding up and administration, the powers of the company's officers are not strictly affected during the receivership. However, practically – particularly where a receiver has been appointed to all of the assets of a company - directors will have little left to do other than attend to their statutory obligations.

Another difference from administration and winding up is that the appointment of a receiver to assets of a company imposes no constraints on the shareholders of that company dealing with their shares (although the receiver may also be appointed to those shares if the secured party also had security over some or all of the shares).

The receiver takes the assets to which he or she is appointed subject to prior equities and other security interests with higher priority.

The appointment of a receiver does not, of itself, constitute a repudiation of contracts to which the company is a party. As a result of the *ipso facto* reforms to the Corporations Act which became effective from 1 July 2018, there is now a general prohibition in a receivership (involving the whole or substantially the whole of a company's property) on counterparties relying on *ipso facto* clauses to terminate for an insolvency event of default (subject to a range of exclusions).

Although the receiver does not have the formal power to disclaim contracts as a liquidator does, the receiver may repudiate some contracts requiring performance by the company, leaving counterparties to pursue their entitlement to damages for breach of contract against the company (which may – if the company is in administration or being wound up – have the effect that the claim can only be pursued by lodging a proof of debt and participating pro rata for whatever is available for the payment of unsecured creditors).

There is no moratorium or stay on the enforcement of claims against the company in receivership, as there is in administration and winding up. This is one reason why there is often a concurrent administration with a receivership, as the receiver will effectively have the benefit of the statutory moratorium applicable in administration.

As with administration, the receiver is personally liable for debts incurred in the course of the receivership for services rendered, goods purchased or property hired, leased or occupied, a statutory obligation that does not extend to pre-appointment liabilities. The receiver has an equitable right of indemnity from the assets of the company, as well as (usually) an indemnity from his or her appointor.

Creditors' claims and priority

A receiver only attends to payment of the secured creditor's debt from the proceeds of realisation of the secured assets, returning any surplus to the company, and is not responsible for dealing with the claims of unsecured creditors. If the company is insolvent, the administrator or liquidator will be responsible for dealing with unsecured creditor claims. However, the secured creditor's claim to assets subject to a circulating security interest – usually cash, receivables, inventory and similar assets – is statutorily subordinated to specified employee claims that qualify for priority in a winding up, being wages and superannuation, leave and redundancy entitlements.

The section 420A obligation

A fundamental and distinctive feature of receivership is the obligation imposed by section 420A of the Corporations Act on a receiver (or other form of controller) in exercising a power of sale in respect of property of a corporation, to take all reasonable care to sell the property for market value (assuming the property has a market value when it is sold) or otherwise, for the best price reasonably obtainable having regard to the circumstances existing when the property is sold. There is no direct equivalent obligation in relation to administrators or liquidators.

This obligation is designed to ensure that the receiver does not simply sell the property that is subject to the security interest for an amount sufficient to pay the secured creditor in full. Instead, the receiver is obligated to obtain the best possible price for the property to ensure that whatever surplus equity there is in the property is available for subsequent secured creditors, unsecured creditors or the company (as applicable).

It is the obligation imposed on receivers by section 420A that means they will often undertake public auction and tender processes to sell property to which they have been appointed.

However, there is no obligation on a receiver to sell the property to which they have been appointed at a particular time, and so it is possible that, once appointed, the receiver may be in possession of the property, and – if applicable – to trade the business, for some time.

The role of the Court in receivership

Usually, private receiverships will not have any Court involvement. Having said that, a receiver, like a liquidator and an administrator, can seek directions from the Court and is subject to the supervision of the Court. In addition, creditors and other persons aggrieved by an act, omission or decision of an receiver can appeal to the Court.

Concurrent voluntary administration/winding up and receivership

It will often be the case that voluntary administration and/or winding up take place concurrently with receivership.

In the case of a receivership that takes place concurrently with an administration, the receiver will effectively have the benefit of some of the administration moratorium provisions (such as that any landlord of premises occupied by the company cannot take possession of the premises during the period of the administration without the consent of the administrator or the leave of the Court), the receivers being personally liable for post-appointment rent if he or she elects to cause the company to remain in possession.

A concurrent receivership with a voluntary administration, DOCA or winding up generally means that:

- the receiver will have control of the assets of the company, and be responsible for trading on its business. Accordingly, dealings in relation to operational matters (such as continued supply to the company, or the continued performance by the company of its contractual obligations) or in connection with the sale of assets, are appropriately conducted by the receiver;
- the claims of unsecured creditors are progressed by way of the administration, DOCA or winding up. Meetings of creditors will be held by the administrator, deed administrator or liquidator, and accordingly proofs of debt and proxies are lodged with the administrator, deed administrator or liquidator, who will adjudicate on creditors' claims.

Winding up in insolvency

Overview

A winding up (also known as a liquidation) in insolvency is a terminal procedure intended to realise a company's assets and distribute them amongst its creditors in accordance with the priorities in the Corporations Act.

For an insolvent company, a winding up can take the form of either a Court ordered or compulsory winding up or a creditors' voluntary winding up.[3]

Commencement of the winding up

A Court ordered or compulsory winding up can only be effected by an order of the Federal Court of Australia or Supreme Courts of the States and Territories of Australia.

Creditors of the company and certain other eligible applicants can apply to the Court to have a company wound up on a range of bases including insolvency. The most common ground for a winding up application in insolvency is the company's failure to comply with a creditor's statutory demand for payment. Failure to comply within 21 days of the statutory demand being issued gives rise to a statutory presumption of insolvency.

If the winding up application is successful, the Court will order that the company be wound up. Upon making a winding up order, the Court will appoint a liquidator. The selection of the liquidator can be nominated by the creditor filing the winding up application by filing a "consent to act" signed by the preferred liquidator or made by the Court, so long as the liquidator is a registered liquidator with ASIC.

A creditors' voluntary winding up usually commences either:

- pursuant to a special resolution of the company's members in circumstances where there is no declaration of solvency made by the directors of the company; or
- as is now more common, by resolution of creditors at a second meeting of creditors in the voluntary administration of the company.

A liquidator appointed in a creditors' voluntary winding up must be a liquidator, appropriately qualified and registered with ASIC, and not disqualified from accepting the appointment.

It is normal to have two or more liquidators appointed jointly and severally, to ensure appropriate continuity in the event of absence or ill health.

Role and powers of the liquidator

Once appointed, a liquidator takes control of the company from the directors and acts as the agent of the company. A liquidator is a fiduciary and, as an officer of the company, subject to the duties applicable to company officers.

The liquidator's primary duties are to preserve, collect and sell the assets of the company, and then distribute the available proceeds as required by the Corporations Act.

3 This document does not deal with winding up a solvent company.

The liquidator has extensive powers, including to compel production of books of the company and to investigate the company's affairs including by way of public examinations of officers or persons otherwise involved in the affairs of the company.

As a general proposition, a liquidator will not trade on a company that is being wound up, as the winding up procedure is terminal.

Impact of the winding up

The powers of the directors are suspended in a winding up.

A transfer of shares in a company, or an alteration of the status of its shareholders, after the commencement of a winding up is void unless with the consent of the liquidator or pursuant to an order of the Court.

Upon a winding up, there is a statutory stay of proceedings against the company, and a prohibition on enforcement (by unsecured creditors) against the property of the company, other than with the consent of the liquidator or leave of the Court. Unsecured claims against the company should generally be pursued by the proof of debt procedure (discussed below).

Dealings with the property of the company after a winding up other than by the liquidator are void.

In terms of the impact of winding up on contracts, it would be usual that winding up would give a counterparty a contractual right to terminate the contract and liquidation - as a terminal insolvency regime - is considered to effect a repudiation of the company's contractual obligations. A liquidator also has the power to disclaim onerous property of the company – such as land burdened with onerous covenants or unsaleable property including contracts that are unprofitable.

Committee of inspection

A committee of creditors, called a committee of inspection, may be appointed. Essentially, the committee of inspection is available to consult with the liquidator and has powers to approve specified transactions of the company entered into during the liquidation and the remuneration of the liquidator.

The role of the Court in winding up

A compulsory or Court-ordered winding up can only be commenced by an order of the Court. However, a creditors' voluntary winding up may commence without any Court involvement.

The Court has a range of powers in connection with a company's winding up, and liquidators can seek directions from the Court and are subject to the supervision of the Court. Creditors and other persons aggrieved by an act, omission or decision of a liquidator (including the adjudication of their proof of debt) can appeal to the Court.

Creditors' claims and priority

In a winding up, all unsecured creditors with debts or claims (including contingent and future claims, and unliquidated claims) against the company, are entitled to participate for dividend from the available assets in respect of their debt or claim, if the circumstances giving rise to their debt or claim arose before the relevant date. The relevant date is usually the date on which the winding up order was made, or the date of the appointment of the administrator if the winding up was preceded by a voluntary administration. There are set off rights where a creditor also has a liability to the company, assuming the necessary mutuality.

Claims are submitted to, and adjudicated on by the liquidator in a quasi-judicial capacity, pursuant to the proof of debt procedures specified in the Corporations Act and Insolvency Practice Rules. If a proof of debt is rejected in whole or in part, there are appeal rights.

Secured creditors are entitled to enforce their security interest during the liquidation, assuming it is not void as against the liquidator (as a matter of law - such as if the security interest has not been perfected within the applicable statutory timeframes - or by reason of a Court order). However, the secured creditor's claim to assets subject to a circulating security interest – usually cash, receivables, inventory and similar assets – is statutorily subordinated to specified employee claims that qualify for priority in a winding up, being wages and superannuation, leave and redundancy entitlements.

Specified debts and claims will take priority over the claims of unsecured creditors in liquidation, being in general terms:

- expenses incurred by an administrator or liquidator in preserving and realising the property of the company;
- the costs and expenses of obtaining any order for liquidation; and
- priority employee entitlements.

The Commonwealth has established the Fair Entitlements Guarantee or "FEG", under which employees of a company that is wound up may be eligible to receive a payment from the Commonwealth in respect of specified entitlements up to a maximum amount. The Commonwealth then subrogates to the position of the employees for the distribution of dividend in the winding-up.

The Corporations Act provides for an automatic set off on in winding up where a creditor has a debt or claim it asserts against the company, and the company also has a debt or claim it asserts against the creditor, such that only the net balance will be a claim of or against the company. The set off will not apply where the debts or claims are not held in the same capacity, or where the creditor had knowledge of the company's insolvency at the time it gave or received credit to or from the company.

There is also capacity under the Corporations Act for creditors whose claim against the company is insured to obtain any insurance proceeds received by the company.

All other unsecured debts rank equally according to the *pari passu* principle and if the property of the company is insufficient to meet them in full, they must be paid proportionately. The Australian Taxation Office **(ATO)** no longer has any priority for amounts owing to it, but has significantly enhanced powers to pursue directors for

unpaid company taxes and can also pursue directors to recover any amounts it is required to disgorge to the company's liquidator as unfair preferences (discussed below).

Liquidator recoveries

Liquidators have the power to investigate the affairs of the company and to take appropriate legal action against directors or third parties to recover certain assets or undo certain transactions for the purpose of increasing the estate available for distribution to unsecured creditors.

Increasingly, third party funding (including from litigation funders) is available for liquidators to pursue investigations (such as by undertaking public examinations) and liquidator recovery actions. However, such litigation is generally protracted, particularly given that whether, and if so when, the company was insolvent is inevitably in issue, which delays dividends being paid.

The primary tools for recovery by a liquidator are voidable transactions (which include unfair preferences and uncommercial transactions) and insolvent trading claims. There are other causes of action available to liquidators, including in relation to unfair loans and unreasonable director-related transactions, that are beyond the scope of this document.

Unfair preferences

Unfair preferences are the most common type of liquidator recovery.

An unfair preference is a payment made to, or benefits received by, a creditor of the company in respect of an unsecured debt owed by the company within a period of six months prior to the deemed commencement of the winding up,[4] if:

- that unsecured creditor has been preferred over other unsecured creditors (i.e. the creditor has received more than if they had proved in the winding up in respect of the debt and participated *pari passu* for dividend); and
- the payment or benefit was received at a time when the company was insolvent or the company became insolvent as a result of making that payment or giving that benefit.

A payment received by a creditor can still be a preference notwithstanding that the creditor provided real consideration (normally the supply of goods or services) to the company in return for the payment the liquidator seeks to recover. The liquidator's right to recover unfair preferences is designed to ensure equity as between unsecured creditors and to ensure that some unsecured creditors are not preferred to the detriment of others.

However, in circumstances where the company and the creditor have a continuing business relationship (also referred to as a running account), involving a series of transactions and movements in the net indebtedness of the company to the creditor from time to time, generally any preferential effect will be considered not in relation to each individual payment made by the company to the creditor, but over the course of the relationship. Essentially this recognises that the creditor has provided real consideration to the company during the relationship, and will generally mean that the amount of the unfair preference is any net reduction in the indebtedness of the company over the period of the relationship (up to the statutory six months prior to the deemed commencement of the liquidation in respect of which unfair preferences can be recovered).

There are potential defences to an unfair preference claim, most commonly if the creditor can establish that they:

- became a party to the transaction in good faith;
- had no reasonable grounds for suspecting that the company was insolvent at the time or would become insolvent as a result of the transaction and a reasonable person in their circumstances would have had no such grounds for so suspecting; and
- have provided valuable consideration or changed their position in reliance on the transaction.

4 This is known as the relation-back day. It is important to note that depending on the circumstances of the winding up and its commencement, the relation-back day calculation can change. Section 91 of the Corporations Act comprehensively outlines the process for calculating the relation-back day. An explanation of each of these circumstances is beyond the scope of this document.

This defence is difficult to establish in practice, as normally payments will have been received as a result of pressure from the creditor asserted because of concerns about the company's solvency, and there will usually be a document trail to this effect which evidences a suspicion of insolvency.

Uncommercial transactions

An uncommercial transaction of the company entered into within two years prior to the deemed commencement of the liquidation is voidable on the application of the liquidator if it was entered into or given effect to at a time when the company was insolvent, or if the company became insolvent as a result of it entering into the transaction.

Whether a transaction is "uncommercial" is assessed by reference to, among other factors, the benefits and detriment to the company and to other parties of entering into the transaction. The test for what constitutes an uncommercial transaction has been expressed as "a bargain of such magnitude that it could not be explained by normal commercial practice." Although the quintessential uncommercial transaction is a disposition of company property at an undervalue (such as in phoenix company conduct), the concept is not so limited.

There are potential defences to an uncommercial transaction claim, most commonly if the defendant can establish that they:

- became a party to the transaction in good faith;
- had no reasonable grounds for suspecting that the company was insolvent at the time or would become insolvent as a result of the transaction and a reasonable person in their circumstances would have had no such grounds for so suspecting; and
- have provided valuable consideration or changed their position in reliance on the transaction.

Insolvent trading

Under the Corporations Act, directors have a positive duty to prevent the company from trading while insolvent. If the company incurs a debt while insolvent or becomes insolvent as a result of incurring that debt, and a director at the time the debt is incurred is aware that there are grounds for suspecting the company is insolvent, or a reasonable person in a like position in the company's circumstances would be so aware, that director will have breached their duty by failing to prevent the company from incurring that debt. Insolvent trading can also be a crime where dishonesty is involved.

There are only limited defences available to an insolvent trading claim, including that, when the debt was incurred, the director:

- had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent;
- had reasonable grounds to believe that a competent and reliable person was fulfilling their obligation to provide adequate information as to whether the company was solvent and would remain solvent, and expected, on the basis of this information, that the company was solvent and would remain solvent;
- did not take part in the management of the company;
- took all reasonable steps to prevent the company incurring the debt (including whether the person took steps to appoint an administrator to the company); or
- is able to rely on the safe harbor provision, section 588GA of the Corporations Act (discussed further below).

If a director has been found to have breached the duty to prevent insolvent trading, the liquidator may recover from the director, as a debt due to the company, the amount of any loss or damage suffered by an unsecured creditor whose debt was incurred while the company was insolvent. In limited circumstances, the affected creditor can sue for recovery of its loss and damage directly.

Australia's insolvent trading laws are particularly onerous and are actively enforced by liquidators and, on occasion, by ASIC. Directors' apprehension of potential personal liability for insolvent trading will often compel them to appoint an administrator.

Safe harbour from insolvent trading liability

2017 saw the introduction into the Corporations Act of section 588GA, the safe harbor provision which effectively operates as a defence to insolvent trading liability.

The safe harbor only applies in relation to a debt if at a particular time after the director starts to suspect the company may become or be insolvent, they start developing one or more courses of action that are reasonably likely to lead to a better return for the company and the debt is incurred directly or indirectly in connection with any such course of action during the period starting at that time and ending at the earliest of:

- if the person fails to take any such course of action within a reasonable period, the end of the reasonable period;
- when the person ceases to take any such course of action;
- when any such course of action ceases to be reasonable likely to lead to a better outcome for the company; and
- the appointment of an administrator or liquidator to the company.

In determining whether the course of action is reasonably likely to lead to a better outcome, the Court can have regard to a list of non-exhaustive factors including whether the director:

- properly informed themselves of the company's financial position;
- took appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the ability of the company to pay its debts;
- took steps to ensure the company kept appropriate financial records consistent with the size and nature of the company;
- obtained advice from an appropriately qualified entity or entities who was or were given sufficient information to give appropriate advice; or
- developed or implemented a plan for restructuring the company to improve its financial position.

Directors seeking to rely on the safe harbour bear the evidentiary burden that they have taken appropriate steps.

Additionally, to ensure the safe harbor is available the director must ensure that employee entitlements are paid when due and all ATO documents are lodged when required and co-operate with any external administrator (if appointed).

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