Chapter 25

Bankruptcy and Insolvency

Learning Objectives

At the end of this chapter, students should be able to:

- understand the meaning, purposes and effects of personal bankruptcy;
- explain the duties and obligations of the trustee in bankruptcy;
- understand what is meant by the term 'corporate insolvency';
- understand and be able to explain the duty of directors to prevent insolvent trading and the consequences for directors who breach the duty;
- understand the features of the three main forms of external administration – receivership, voluntary administration and liquidation;
- explain the order of priority that debts are paid on the winding up of a company; and
- understand the need for reform of insolvency laws and the main features of the government's 2006 reform package.

Lecture Outline

Personal bankruptcy:

A person is considered to be bankrupt if they are unable to pay their debts as and when they fall due from their own money. There are two types of bankruptcy:

(i) voluntary; and
(ii) involuntary.

Purposes of bankruptcy: bankruptcy regulates the distribution of assets owned by the bankrupt. The bankrupt is prevented from entering into certain transactions during the course of the bankruptcy, but he or she will eventually be released from their debts.

Effects of bankruptcy on the person declared bankrupt: they are relieved from liability for their debts on the one hand, but their property is taken away from them for the benefit of their creditors on the other. Further obligations and restrictions are also imposed on them: see textbook.

Outline the powers and duties of the trustee in bankruptcy, who is the person charged with administering the estate of the bankrupt.

Corporate insolvency:

A company is considered to be insolvent if it is unable to pay its debts as and when they fall due: s 95A *Corporations Act.* Control of the company is then handed from the directors to an external administrator.

There are three main forms of external administration:

(i) receivership;
(ii) voluntary administration; and
(iii) winding up by a liquidator.

Note that since the introduction of voluntary administration, creditors' schemes of arrangement have not been popular.

Directors' duty to prevent insolvent trading:

Since corporate insolvency is one of the main reasons leading to external administration, it is useful to remind students at this point of the directors' duty to prevent insolvent trading under s 588G of the *Corporations Act.* Directors who breach this duty are held personally liable for insolvent trading by a company.

Note the defences available to directors under s 588H of the *Corporations Act.*

Receivership:

Purpose: the objective of receivership is to appoint a suitably qualified person (usually a person whom ASIC has registered as a liquidator) to assume control over some or all of the company's assets or property in the interests of a secured creditor.

Appointment of receiver or receiver/manager: usually appointed by a bank, financial institution or other secured creditor under the terms of the relevant charge. May be appointed by a Supreme Court or the Federal Court, but this method is rare.

Powers: the scope of their appointment will determine the range of powers of the receiver. A simple receiver only exercises control over the property charged in order to sell it and repay the debt owed to the secured creditor. In the case of a general receivership, which is more common, the receiver/manager controls most of the company's property and has power to manage the business as well as realising the company's assets for the benefit of the secured creditor. Section 420 (general powers), s 430 (power to require books) and s 431 (power to inspect books) of the *Corporations Act* confer additional powers.

Duties: receivers and receivers/managers are subject to a wides range of duties both at common law and under the *Corporations Act.* In addition receiver/managers are "officers" of the company for the purposes of the officers' duties provisions of the *Corporations Act.*

Liabilities: as company "officers", receivers are subject to the civil penalty regime of the *Corporations Act.* Receivers can be liable for breaches of duty under the *Corporations Act* (see ss 419 and 419A – liability of controller - and s 420A – controller's duty of care in exercising power of sale). Note that receivers, and receiver/managers, come within the definition of "controller". Receivers may also be liable under s 232 (oppressive conduct of affairs) and s 598 (orders against a person in relation to a corporation). A receiver may be able to insist on an indemnity from the secured creditor who appointed them. Provided the receiver was not dishonest, they will be reimbursed for liabilities incurred during the course of the receivership.

Voluntary Administration:

Purpose: voluntary administration quarantines the company for a certain period of time from claims made by creditors. The idea is to see whether it is possible for the administrator to trade the company out of its financial difficulties with a view to continuing in business. If this is not possible, then the objective is to maximise the return to creditors and members.

Appointment of administrator: either by the directors of the company; a liquidator or provisional liquidator; or a secured creditor who holds a charge over the whole, or substantially the whole, of the company's property.

Powers: the administrator has control over, and may manage the company's business, property and affairs. During the administration, the administrator acts as the company's agent and the powers of the other company officers are suspended. In addition to these general powers, the administrator has certain specific powers, such as the power to remove a director from office, appoint directors, execute documents and bring proceedings.

Duties: s 438A sets out the main duties of the administrator. See the textbook for the meetings that the administrator must convene within the strict time limits specified. The majority of administrations last about a month. Administrators are also "officers" of the company for the purposes of the officers' duties provisions of the *Corporations Act.*

Liabilities: as company "officers", administrators are subject to the civil penalty regime of the *Corporations Act.* They are also liable for the debts they incur in the performance of their functions, but they may be indemnified out of the company's assets for their debts.

Liquidation (winding up):

Purpose: to wind up the affairs of the company, collect and then sell its assets, pay its debts and distribute any remaining surplus to the members. Following liquidation (winding up), ASIC will de-register the company. The main objective is to maximise returns for the unsecured creditors, such as trade creditors. In other words, a liquidator essentially acts for the unsecured creditors of the company.

Appointment of liquidator: in a voluntary winding up, either by the members where the company is solvent; or by the creditors, where the company is insolvent.

In a compulsory winding up, the liquidator is appointed by the court. The basis may be, for example, insolvency, oppression, or the just and equitable ground: see s 461 of the *Corporations Act.*

Powers: a liquidator is rarely involved in conducting the company's business on an ongoing basis. The powers of liquidators relate to taking possession of, and then disposing of, the company's assets at the best possible price. They may therefore make calls on the owners of partly paid shares for the balance owing on those shares. They may, where appropriate, bring an action for insolvent trading by directors; recover sums under the voidable transaction provisions; and seek compensation from officers who are in breach of the officers' duties provisions.

Duties: there are numerous duties relating to the proper keeping of records and books and the lodgement of notices and reports with ASIC. Liquidators must also report breaches of the law to ASIC. They also owe fiduciary duties to the company and, like receivers and administrators, are "officers" of the company for the purposes of the officers' duties provisions of the *Corporations Act.*

Liabilities: if a liquidator breaches either their fiduciary duties to the company, or any of the officers' duties provisions, they may be liable to pay compensation to the company or be subject to civil penalties.

The order or priority of debts on winding up:

The effect of the relevant provisions in the *Corporations Act* is that, after secured creditors have been satisfied, the liquidator is obliged to distribute whatever funds are available for distribution in the following order of priority:

(i) expenses properly incurred in the course of the winding up;
(ii) outstanding wages and other employee entitlements;
(iii) unsecured creditors; and
(iv) if there are outstanding moneys after creditors have been paid in full, then members of the company are entitled to the surplus.

Issues relating to reform:

Outline the impetus for reform of Australia's insolvency laws and how the Federal Government is proposing to deal with the four main areas targeted for reform:
(i) strengthening creditor protection
(ii) deterring misconduct by company officers
(iii) improving the regulation of insolvency practitioners; and
(iv) enhancing the efficiency and cost-effectiveness of voluntary administration.

Tutorial Exercises

Answers to short-answer questions

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1. Bankruptcy and insolvency both mean an inability to pay debts as and when they fall due. Bankruptcy refers to an individual person's inability to pay their debts as and when they fall due, whereas insolvency refers to a corporation's inability to pay its debts as and when they fall due.

Broadly speaking, the effects of bankruptcy and insolvency are far-reaching and similar in some respects. They both involve an external party taking control of the bankrupt's or the company's business and financial affairs (or some aspect of it, as in the case of a receiver) – in the case of a bankrupt, that third party is a registered trustee of bankruptcy or the Official Trustee; in the case of an insolvent company, it is a receiver (or receiver/manager), a voluntary administrator or a liquidator.

2. Bankruptcy and insolvency are each regulated for a number of reasons that broadly promote the interests of creditors. Bankruptcy facilitates the orderly distribution of assets owned by the bankrupt amongst creditors. It imposes a number of duties on the bankrupt in order to facilitate the bankruptcy process. It imposes a wide range of restrictions on the bankrupt in order to limit their ability to incur further debts during the course of the bankruptcy. Ultimately, the regime releases the bankrupt from their debts in an attempt to enable them to start anew.

Insolvency serves a number of purposes in the corporate context. The main objective depends upon the type of external administrator appointed:
(i) the function of receivership is to protect some or all of the company's assets or property in the interests of the secured creditor. The goal is to cancel or reduce the debt owed to the secured creditor.
(ii) the objective of voluntary administration is to give the company a realistic chance of trading its way out of its financial difficulties and if this is not possible, then to maximise the return that creditors and members receive on the eventual winding up of the company.
(iii) the objective of liquidation is to bring about the de-registration of the company and to facilitate the orderly distribution of the company's assets in the statutory order of priority.

The effect of bankruptcy on the bankrupt is that they are released from their debts, but in return, they are required to surrender their property to the trustee in bankruptcy for distribution to their creditors in the prescribed manner. In addition, they may be subject to a wide range of duties and restrictions and possible penalties.

The effect of insolvency on the company is that:
(i) in the case of receivership, the receiver takes control of the secured asset. The powers of management of the directors are suspended to the extent that the receiver exercises those powers;
(ii) in the case of voluntary administration, the administrator has control over, and may carry on and manage, the company's business, property and affairs. During that time, the administrator acts as the agent of the company and the powers of the other company officers are suspended;
(iii) in the case of liquidation, the liquidator is rarely involved in conducting the business affairs of the company on an ongoing basis. The objective of liquidation is to bring about deregistration of the company. The company is managed by the liquidator and the powers of the other company officers are suspended.

3. For the powers, duties and liabilities of a receiver (and receiver/manager), an administrator and a liquidator, see the Lecture Outline (above).

4. In order to avoid liability for insolvent trading, a director of a company in financial difficulty should arrange for the appointment of a voluntary administrator. This option provides the best chance of the company trading its way out of financial difficulty (if this is at all possible), as well as protecting the director from personal liability at least in the short term. It will be remembered that one of the defences to insolvent trading under s 588G is that the director took all reasonable steps to prevent the company from incurring the debt: s 588H. Arranging for the appointment of a voluntary administrator amounts to "taking all reasonable steps".

5. Voidable transactions for the purpose of bankruptcy law are certain fraudulent or preferential transactions entered into by a bankrupt. Specifically they are:
(i) undervalued transactions;
(ii) transfers to defeat creditors; and
(iii) preferences.

These are more fully described in the textbook.

Voidable transactions for the purpose of insolvency law are certain unfair preferences or uncommercial transactions which the company entered into in the period leading up to its winding up and which the liquidator can reverse. An unfair preference is a transaction that places an unsecured creditor in a better position than they would have been in had they been obliged to prove for the debt in the liquidation. An uncommercial transaction is one that no reasonable person would have entered into having regard to its benefits and drawbacks to the company, its benefits to other parties and all relevant circumstances.

An unfair preference or an uncommercial transaction will amount to a voidable transaction if it occurred when the company was insolvent or if it caused or contributed to the company's insolvency.

Section 588FE of the *Corporations Act* lists the five types of voidable transactions. Refer to the textbook.

6. Section 555 of the *Corporations Act* gives effect to the *pari passu* principle. This states that, except as otherwise provided by the Act, all debts and claims proved in a winding up rank equally and, if the property of the company is insufficient to meet them in full, they must be paid proportionately. This means that, apart from certain payments which have been given priority (such as the costs of the liquidator and certain employee entitlements), the company's assets must be distributed to all unsecured creditors on an equal basis.

The order of priority for payment of debts on winding up of a company is:

i) expenses properly incurred in the course of the winding up;
(ii) outstanding wages and other employee entitlements;
(iii) unsecured creditors; and
(iv) if there are outstanding moneys after creditors have been paid in full, then members of the company are entitled to the surplus.

7. "Pooling" in the context of a group liquidation refers to the ability to override the separate legal entity concept as established in *Salomon's case.* Under the *Salomon* principle, each company in a corporate group is regarded by the law as separate and distinct even though they may, to all intents and purposes, operate commercially as a single enterprise.

"Pooling" means that companies involved in a group liquidation would not be treated as separate legal entities. Under the proposal, liquidators of companies involved in a group liquidation would, subject to the consent of all unsecured creditors or with the court's approval, wind them up as if they were one entity. All their assets and liabilities would be pooled by the liquidator and made available to the unsecured creditors. This would enable unsecured creditors to have access to all the proceeds of sale of the assets of other companies in the group.

The merit of the proposed pooling arrangements is that it gives recognition to the commercial realities of companies operating in a group. Pooling of assets overcomes the technicalities of the separate legal entity concept. By enabling the liquidator to pierce the corporate veil of companies in the group, pooling produces a better financial outcome for the unsecured creditors.