Baker McKenzie.

Global Restructuring & Insolvency Guide

Australia

Overview and Introduction

Australia has two separate but similar regimes operating in respect of insolvency, one for insolvent individuals and the other for insolvent corporations.

This Guide discusses the various formal insolvency administrations for an insolvent individual or corporation, as well as methods to "turn around" corporations to solvent positions.

In Australia, there appears to be a continuing trend towards interventions before insolvency as well as an increasing proportion of administrations that seek to rescue and rehabilitate the person or the company, both with the aim of providing larger returns to creditors than would otherwise be available if a formal bankruptcy or liquidation regime were put in place.

Applicable Legislation

The insolvency regime in Australia is primarily governed by the *Corporations Act 2001* (the "**Corporations Act**") and its associated regulations, which provides the legislative framework for corporate insolvencies, and the *Bankruptcy Act 1966* (the "**Bankruptcy Act**") and its associated regulations, which provides a statutory regime for insolvent individuals.

Additional laws may interact with the administration of an insolvent individual or corporation.

Types of Insolvency Administrations

In personal insolvency, an individual may be subject to any of the following regimes:

- Bankruptcy; or
- Arrangements without bankruptcy (personal insolvency agreements and debt agreements).

A company in serious financial difficulty may be placed into external administration. There are five types of external administrations:

- Receivership;
- Voluntary administration;
- Deed of company arrangement ("**DOCA**");
- Scheme of arrangement; or
- Liquidation or winding up (including provisional liquidation).

These various types of external administrations may overlap or follow one another. At the successful conclusion of a receivership, voluntary administration, DOCA or scheme of arrangement the company may be able to continue to trade. However, a liquidation is typically a terminal administration, the purpose of which is to deregister the company. It may be the inevitable outcome for a hopelessly insolvent company, regardless of which external administration is first implemented.

Meaning of Insolvency

Both the Corporations Act and the Bankruptcy Act define "solvent" as follows[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.*"

Under both Acts, a person who is not solvent is insolvent.[2] This definition is important because many of the formal insolvency regimes discussed below can be implemented only in circumstances where a company or a person is insolvent or nearing insolvency.

Personal Insolvency

Bankruptcy

Bankruptcy is an insolvency administration for individuals that gives the insolvent individual protection from creditors while allowing for the orderly realisation of assets and a fair distribution to creditors through sequestration of the debtor's estate. It has many similarities to a winding up of a company.

Bankruptcy can be initiated:

- At the request of the debtor (voluntary bankruptcy); or
- At the request of a creditor (involuntary bankruptcy).

Voluntary Bankruptcy – Debtor's Petition

The most common way for an insolvent individual to become bankrupt is the presentation of his or her own petition (a prescribed form) to the Official Receiver. No application needs to be made to a court. If the petition is accepted by the Official Receiver, the individual becomes bankrupt with effect from the date of acceptance.

Involuntary Bankruptcy – Creditor's Petition

Creditors of the individual may also apply to the Federal Court of Australia or the Federal Circuit Court of Australia by way of a creditor's petition to have the individual made bankrupt. The creditor must be owed at least AUD 5,000 by the individual, and the individual must have committed an act of bankruptcy within six months preceding the creditor's petition being filed. The most common act of bankruptcy relied on by creditors is the failure of the individual to comply with a bankruptcy notice issued at the request of the creditor in relation to a debt that is the subject of a final judgment or order of the court. The individual must comply with the bankruptcy notice within 21 days of it being served on the individual.

If the application is successful, the court will make a sequestration order, making the individual bankrupt and vesting the bankrupt's estate in a trustee in bankruptcy.

Role of the Trustee in Bankruptcy

The trustee is in a very similar role to that of a liquidator. However, unlike a liquidator, the assets of the bankrupt vest in the trustee. The trustee's primary roles and duties are to collect, preserve and sell the divisible assets of the bankrupt;[3] assess if the bankrupt should be making income contributions to the estate; and distribute the available proceeds to creditors in the order regulated by the Bankruptcy Act.[4] A trustee must also investigate the affairs of the individual before he or she was made bankrupt.

---

[1] See s 95A of the Corporations Act and s 5 of the Bankruptcy Act.

[2] See s 95A(2) of the Corporations Act and s 5 of the Bankruptcy Act.

[3] The assets available exclude certain assets exempted by the Bankruptcy Act but include certain assets acquired by the bankrupt and certain income earned by the bankrupt after the bankruptcy commenced and before the bankrupt is discharged from the bankruptcy.

[4] See s 19 of the Bankruptcy Act for a list of trustees duties and s 134 of the Bankruptcy Act for a list of trustee's powers.

Once the distribution of the estate funds (if any) to creditors is complete, the trustee may be released from the estate.

Termination of the Bankruptcy

Typically, the bankrupt will be discharged or released from bankruptcy automatically after a period of three years[5] from the date the bankrupt files a statement of affairs.[6] However, the bankrupt may be discharged earlier in certain circumstances.

A discharge operates to release the individual from all debts (except secured debts) that were provable in the bankruptcy.

Clawback and Recovery Mechanisms (Antecedent Transactions)

The Bankruptcy Act contains avoidance provisions that enable a trustee to challenge particular transactions that may be considered void against the trustee. The avoidance provisions are similar to those in the Corporations Act.

Below are examples of the transactions that are deemed to be void against the trustee.

- *Undervalued transactions.* A transfer of property by a person who later becomes bankrupt, where the transferee gave no consideration for the transfer or gave consideration of less than market value, and the transfer took place within the five years prior to the commencement of the bankruptcy.

- *Transfers to defeat creditors.* A transfer of property by a person who later becomes bankrupt where the transferor's main purpose in making the transfer was to prevent the transferred property from becoming divisible among the transferor's creditors, or to hinder or delay the process of making the property available for division amongst creditors, and the property, had it not been transferred, would have probably become part of the bankrupt estate. There is no time limit.

- *Consideration to a third party.* If there is a transfer of property as described above but instead of the transferee giving consideration to the bankrupt, the transferee gives the consideration to a person other than transferor (a third party), and that third party has not in turn provided consideration to the bankrupt, the trustee may be entitled to recover the benefit from the third party for the benefit of the bankrupt estate.

- *Preferences.* A transfer made by person who is insolvent in favor of a creditor, if the transfer has the effect of giving the creditor a preference, priority or advantage over other creditors, where the transfer took place within the six months prior to the deemed commencement of the bankruptcy (that varies depending on the method by which the bankruptcy commenced).

- *Superannuation contributions made to defeat creditors.* Superannuation or pension funds are generally not divisible among creditors. However, a trustee is entitled to claw back superannuation contributions made by a person who later becomes bankrupt, or superannuation contributions made by a third party for the benefit of a person who later becomes bankrupt, if it can be established that the main purpose of the transfer was to defeat the bankrupt's creditors, or to hinder or delay the process of making the property available for division amongst creditors, and the property, had it not been transferred, would have probably become part of the bankrupt estate. The transfer must have occurred after 28 July 2006 and regard must be had to the pattern of contributions and whether the contribution was "out of character".

---

[5] The Australian Government has proposed to reduce the period of bankruptcy from three years to one year as part of a law reform proposal package released on 29 April 2016. As at the date of publication, a consultation process is underway in relation to this proposal.

[6] Until the bankrupt files a statement of affairs, the three-year period to automatic discharge will not begin to run. The period may be extended by an objection entered by the trustee in bankruptcy in certain circumstances.

Priority of Claims

The general rule is that debts provable in a bankruptcy rank equally according to the *pari passu* principle and if the property of the bankrupt is insufficient to meet them in full, they must be paid proportionately. However, this rule is subject to several exceptions. For example, a secured creditor is entitled to priority for the amount of its debt ahead of unsecured creditors. In addition, the Bankruptcy Act affords special priority to particular creditors, including (but not limited to) the trustee, for their reasonable costs and expenses incurred in relation to the bankrupt estate and to employee wages. Creditors who receive special priority (see below) will be paid ahead of unsecured creditors, and any funds remaining will be paid to unsecured creditors proportionately.

Arrangements with Creditors Made Under the Bankruptcy Act

As an alternative to bankruptcy, an insolvent individual may be able to enter into a formal arrangement or compromise with his or her creditors under the Bankruptcy Act that binds all unsecured creditors.

There are two types of formal arrangements:

- Personal Insolvency Agreements ("**PIA**") (commonly referred to as a Part X agreement); and
- Debt Agreements.

These arrangements are all entered into at the initiation of the individual debtor and bear some similarity to a DOCA in respect of a company, as discussed below. Neither requires that an application be filed with a court.

Personal Insolvency Agreement

An individual may initiate a PIA by providing a controlling trustee (who must be a registered trustee in bankruptcy, a solicitor or the Official Trustee) with:

- A draft PIA that set outs what property and income of the debtor is to be made available to pay creditors and how that property and income will be dealt with; and
- An irrevocable authority to act.[7]

The controlling trustee then takes control of the individual's property and affairs, investigates his or her property and affairs and calls a meeting of creditors to consider the draft PIA. The controlling trustee must also provide a report to creditors stating whether the interests of creditors would be better served by accepting the proposed PIA or by the bankruptcy of the individual. A meeting of creditors must be held within 25 to 30 business days of the controlling trustee's appointment,[8] whereby the creditors vote on whether or not to accept the PIA.

If the PIA is accepted by creditors[9] and executed, the controlling trusteeship ends and the trustee of the PIA takes over, administering the terms of the PIA. The PIA does not affect the rights of secured creditors but otherwise binds unsecured creditors, preventing them from enforcing the debts that are the subject of the PIA.

If the PIA ends successfully, the individual is released from those debts that he or she would have been released from had he or she been made bankrupt. If the PIA is not accepted or is terminated for other reasons, the moratorium on the enforcement of unsecured debts referred to above ends and unsecured creditors may enforce their claims, including by filing a creditor's petition to bankrupt the

[7] The provision of an irrevocable authority to act in relation to a PIA amounts to an act of bankruptcy for the purpose of a creditor's petition.

[8] See s 194 for the applicable time limit.

[9] Acceptance occurs when, at a meeting of creditors, a special resolution is passed by a majority of creditors in number, who are owed at least 75% in value of the individual's debts.

individual,[10] or the creditors may resolve to require the individual to present a debtor's petition for bankruptcy.

Debt Agreement

A Debt Agreement is similar to a PIA but less formal and less expensive to implement. It is only available to low-income earners whose debts, income and assets that would be divisible on bankruptcy do not exceed the prescribed limits.[11]

Corporate Restructuring and Insolvency

Insolvency

Corporate Reorganisation or restructure will often be considered when a company is approaching insolvency or is insolvent.

Broadly, under Australian law:

- A company is insolvent when it is unable to pay its debts as and when they fall due, and this is determined by a cash-flow test rather than a balance-sheet test (although balance-sheet solvency may have some relevance to the assessment);
- Solvency is a question of fact to be decided as a matter of commercial reality in light of the circumstances;
- Support available to the company (for example, from other group companies) and any deferral of payment or compromise agreed to by creditors are relevant considerations to determining solvency on a cash-flow test;
- Directors have a duty to prevent the company from trading while insolvent and, in a liquidation, can be held personally liable for the unpaid debts incurred when the company was insolvent (directors could be held criminally liable for insolvent trading if they acted dishonestly and substantial fines and/or imprisonment may be imposed for a criminal conviction);
- In assessing solvency, regard must be had to both debts that are currently due and payable and to future debts and their timeframes for payment; and
- In relation to future debts, directors must have reasonable grounds to expect that the company will be able to pay them as and when they fall due – the closer the time for payment, the more certain or probable must the expectation be.

Restructuring Options

Reorganisation or restructure can occur both informally or via formal processes under Australian insolvency laws (generally under Chapter 5 of the Corporations Act) including, typically, voluntary administration followed by a DOCA or, less commonly, through a scheme of arrangement.

Informal Arrangements

These commonly occur by, for example, the company entering into contractual compromise or standstill arrangements with its creditors, usually involving debt rescheduling. Informal arrangements will often be preferred to formal insolvency as they avoid the loss of value that is usually part of a formal insolvency and enhance the prospect of the company continuing as a going concern.

Informal arrangements are more difficult to achieve than formal arrangements because it only requires one creditor to refuse to participate for the arrangement to fail.

---

[10] The giving of the authority, the calling of the meeting of creditors and the termination of the agreement itself are all "acts of bankruptcy" under s 40 of the Bankruptcy Act and can provide a basis for a creditor's petition.

[11] As at 20 March 2016, the debt and asset limit is AUD $109,036.20 and the income limit is AUD $81,777.15.

Appointment of Investigating Accountant

Before a Reorganisation or restructure occurs, secured creditors may also, under the terms of their security agreement with the company, have the ability to appoint an investigating accountant to review the finances of the company and make recommendations as to ways in which the company could be reorganised to improve its financial position. The investigating accountant will usually be engaged by the company but will also be obliged to provide information to, and owe duties to, the secured creditor. Although the recommendations of the investigating accountant are not binding, in practice, a company wishing to avoid the potential consequences of a breach of the security agreement and/or insolvency is likely to follow at least some of those recommendations.

Voluntary Administration

Overview

The voluntary administration procedure is a short-term insolvency administration designed to maximise the return to creditors by, wherever possible, allowing a company in financial difficulty to continue to trade, so that it can be rehabilitated, be sold as a going concern or, where that is not appropriate, be wound up. There is usually little, if any, court involvement in a voluntary administration.

The voluntary administration process provides a company with a little breathing space during which there is a general moratorium on the enforcement of creditors' claims (with some limited exceptions). The moratorium provided by the voluntary administration process allows any proposals for a longer-term regime for the company's continued existence to be considered. Such proposals typically include a plan under which relations with creditors are regulated and debts compromised.

Australia's voluntary administration procedure has the same aim of rehabilitation as the United States' Chapter 11, but seeks to achieve this objective in some fundamentally different ways:

- The company's directors are not formally removed but their powers are suspended; during the administration the company is under the control of the voluntary administrator, an independent insolvency practitioner;

- The process is creditor-driven rather than debtor-driven, and creditor decision-making is by all creditors voting as a single class; and

- A voluntary administration can take place entirely without court involvement.

An important distinction between voluntary administration and US Chapter 11 is that contractual counterparties of a company in voluntary administration are permitted to terminate their contract with the company if a termination right has arisen, as would usually be the case if a voluntary administrator has been appointed.

Proposals received during the voluntary administration period are typically implemented through a DOCA approved by the company's creditors, which is binding on the company, its shareholders and its creditors.

How is a Voluntary Administration Initiated?

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 and that an administrator should be appointed. Although less common, a secured creditor or a liquidator of the company may also appoint an administrator in certain circumstances.

The written consent of the proposed administrator (who must be a registered liquidator) is required before the appointment.

Once an administrator has been appointed to a company, the company is required to set out in every public document and negotiable instrument the expression "administrator appointed".

Role of the Voluntary Administrator

The administrator takes control of the affairs and business of the company, and acts as an agent of the company. The administrator has broad powers, which include carrying on the business or selling assets of the company. The administrator is personally liable for debts incurred by the company continuing to trade post-appointment and has the right of indemnity supported by a statutory lien over the assets of the company.

The powers of the company's directors are suspended for the administration period.

The administrator must convene two meetings of creditors. The first meeting must occur within eight business days of the administrator being appointed. The first meeting considers if the administrator should be replaced and if a committee of creditors be appointed as an advisory body.[12] The second meeting must occur within 25 business days after the administrator being appointed.[13] The second meeting decides the future of the company, which is discussed in more detail below.

The administration process is intended to be quick, although in more complex administrations (such as of corporate groups), it is usual for the court to extend relevant time limits.

The Moratorium

During the limited period over which the administration usually occurs (intended to be around a month for simple administrations), the company has the benefit of a statutory moratorium during which time (and subject to a few limited exceptions):

- Creditors, including secured creditors, are prohibited from taking any action against the company to recover debts, enforce charges or have the company wound up other than secured creditors with a security interest over the whole or substantially the whole of the company's property who enforce their security within 13 business days;
- Owners or lessors of property that is being used by the company are prohibited from seizing or reclaiming property (although termination notices can be given that take effect after the conclusion of the administration period); and
- Guarantees granted by directors of the company cannot be enforced.

Outcome of the Voluntary Administration

The administrator must investigate the financial situation and affairs of the company and recommend to the company's creditors whether it is in their interests to:

- End the administration and hand the company back into the control of its directors (which rarely happens and is appropriate only if the company is solvent);
- Enter into a DOCA; or
- Have the company wound up by transition to a creditors' voluntary liquidation.

The administration ends when creditors resolve at the second meeting of creditors in the administration to end the administration, proceed to liquidation, or on execution of the DOCA.

To be passed a resolution must obtain a simple majority by number and value, with creditors voting as one class. The administrator has a casting vote if only one of the required majorities is obtained.

---

[12] Under the Insolvency Law Reform Act 2016 (Cth) ("ILRA"), the committee of creditors will be replaced with a committee of inspection. The ILRA has received royal assent; however, these provisions have not yet commenced. They are not expected to commence until March 2017.

[13] This period is extended to 30 business days during the Christmas and Easter period.

Deed of Company Arrangement ("DOCA")

A DOCA is separate from, but necessarily follows, the voluntary administration process discussed above. It commences with the execution of the DOCA approved by the creditors at the second meeting of creditors in the voluntary administration.

A DOCA is a flexible agreement between a company and its creditors that governs the relations between the company and its creditors after the end of the voluntary administration, including the nature and duration of any moratorium period, property available to pay creditors, the scheduling of payments to creditors (usually in accordance with statutory priorities) and the extent of the release of the debts of the company. It 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.

The DOCA itself has very few formal requirements and may be moulded to suit the particular circumstances of the company. For example, it may allow the company to trade on, including under the control of its directors. It will generally provide for a fund to be provided for distribution to creditors and incorporate the liquidation provisions for dealing with creditors' claims (discussed below).

If a company continues to trade on under a DOCA, it is generally required to set out in every public document the expression "subject to a deed of company arrangement".

The DOCA does not affect the rights of future creditors of the company if it continues to trade and incur debts. As noted below in the commentary on schemes of arrangement, a DOCA is not able to effect releases of claims that creditors may have against third parties.

The regime ends when the DOCA is terminated. If the DOCA is terminated because its aims have been met, the company can continue to trade and is returned to the full control of its directors and officers. However, if the DOCA is terminated other than for that reason, it is likely that the company will proceed to liquidation.

Sometimes, the DOCA will terminate promptly after execution and the creditors' claims and the assets intended to meet those claims moved to a separate trust, referred to as a creditors' trust. This is to allow the company to continue to function without strictly remaining subject to a DOCA and the stigma of having to note that it is subject to a DOCA on all public documents.

Schemes of Arrangement

Overview

A company may also be reorganised or restructured through a scheme of arrangement.

Schemes of arrangement have, since the advent of a voluntary administration regime, been more frequently used in the reconstruction or merger of a company or group of companies involving the company's shareholders rather than its creditors (a "**members' scheme of arrangement**") due to:

- The time and cost involved to implement a scheme of arrangement (particularly given the insolvent trading risk for directors); and

- The ability (since 1993) to achieve the same or similar outcomes more quickly and cost-effectively through the voluntary administration process via a DOCA.

However, schemes of arrangement involving a compromise between a company and some or all of its creditors (a "**creditors' scheme of arrangement**") have recently had a resurgence in popularity.

Two Australian decisions have paved the way for a revival of the use of creditors' schemes of arrangement where the reconstruction requires the release of third-party claims by creditors of an insolvent company. The High Court of Australia has held that DOCAs cannot give effect to a release

by creditors of claims against third parties,[14] while the Full Federal Court of Australia has held that in certain circumstances, a scheme of arrangement may be used to achieve that effect.[15] Accordingly, there have been a number of creditors' schemes of arrangement being effected after a company has gone into a formal insolvency, pursuant to which a third party has contributed funds to be available for distribution to creditors in return for releases of that party by creditors, effected by way of a creditors' scheme of arrangement.

Creditors' schemes of arrangement have also been used recently to effectuate the substantial debt-for-equity restructurings of the Alinta Energy group of companies, the Centro Property group and the Nine Entertainment Group. Creditors' schemes of arrangement are potentially attractive in larger restructurings for a range of reasons, including the greater certainty that a restructure effected with court sanction can bring; DOCAs, by contrast, are more susceptible to being subsequently set aside.

How Is a Scheme of Arrangement Effected?

By way of an overview, a creditors' scheme of arrangement involves:

- The court making orders, on the application of the company, for the convening of meetings of the relevant class or classes of creditors for the purpose of considering the proposed scheme of arrangement (the "**first court hearing**"). The Australian Securities & Investments Commission ("**ASIC**") must be given at least 14 days' notice of this application in order to give it sufficient opportunity to consider the relevant material;

- The dispatch to the relevant creditors of an explanatory statement containing prescribed information about the scheme of arrangement;

- The holding of the meeting or meetings ("**scheme meetings**") of the class or classes of relevant creditors to consider the proposed scheme of arrangement. A creditors' scheme of arrangement must be approved by a majority of creditors in the relevant class voting, whether in person or by proxy, being a majority whose debts or claims against the company amount in the aggregate to at least 75% of the total debts or claims against the company of the creditors in that class voting, whether in person or by proxy;

- Assuming the requisite approvals are obtained at the scheme meetings, the court making orders approving the scheme of arrangement (the "**second court hearing**"); and

- The scheme of arrangement becoming effective once the orders approving the scheme are lodged with ASIC.

A scheme administrator, who must be a registered liquidator, will be generally be appointed to give effect to the terms of the creditors' scheme of arrangement.

Liquidation

Liquidation is the procedure by which the affairs of a company are wound up and brought to an end. In Australia, there are three types of liquidation or winding up:

- Compulsory liquidation (including provisional liquidation);

- Creditors' voluntary liquidation; and

- Members' voluntary liquidation.

---

[14] *Lehman Brothers Holdings Inc v City of Swan & Ors; Lehman Brothers Asia Holdings Limited (in liquidation) v City of Swan & Ors* (2010) 240 CLR 509.

[15] *Fowler v Lindholm, In the matter of Opes Prime Stockbroking Limited* (2009) 178 FCR 563.

Compulsory Liquidation (Including Provisional Liquidation)

A compulsory winding up can only be effected by an order of the court. Creditors of the company and certain other eligible applicants can apply to the court to have the company wound up. The most common ground for a winding-up application is the company's failure to comply with a statutory demand. If the application is successful, the court will order that the company be wound up and an official liquidator be appointed to it.

In cases where the assets of the company may be at risk, the court can, on an urgent basis, appoint a provisional liquidator after a winding-up application has been filed and before the making of a winding-up order.

Creditors' Voluntary Liquidation

A creditors' voluntary winding up is initiated by a special resolution of the company's shareholders. A creditors' meeting must be held within eleven days of the shareholders' meeting to confirm the appointment of, or to replace, the liquidator.

Members' Voluntary Liquidation

This method of winding up is available only when the company is solvent and the directors are able to determine that the debts of the company can be paid in full within 12 months of the commencement of the liquidation (and make a declaration to that effect). The winding up commences when the shareholders, by special resolution, vote to wind up the company.

Role of the Liquidator

Once appointed, a liquidator takes control of the company from the directors and acts as the agent of the company.

The liquidator's primary roles and duties are to preserve, collect and sell the assets of the company, and then distribute the available proceeds in the order regulated by the Corporations Act (as discussed further below).

Clawback and Recovery Mechanisms

Liquidators have broad powers 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 creditors. The general acceptance of litigation funding in Australia over recent years has made it easier for liquidators to pursue meritorious recovery actions.

Examples of the recovery mechanisms available are listed below.

- *Insolvent trading.* Under the Corporations Act, directors have a duty to prevent the company from trading while insolvent. If the company incurs a debt while the company is insolvent or becomes insolvent as a result of incurring that debt, and the directors at the time the debt is incurred are 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, those directors will have breached their duty by failing to prevent the company from incurring that debt. There are only limited defences available.

  If a director has been found to have breached this duty, 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.

  A breach of this duty may result in civil penalty orders against the director/s and may amount to a criminal offence if the director's failure to prevent the debt being incurred was dishonest.

- *Breach of general directors' duties.* Directors owe the company a number of general-law and statutory duties including:

(i) Fiduciary duties;

(ii) A duty of good faith;

(iii) A duty to exercise their powers and discharge their duties with care and diligence;

(iv) A duty to exercise their powers and discharge their duties in good faith and for a proper purpose; and

(v) A duty to not use their position improperly or improperly use information gained through their position to gain an advantage for themselves or others, or cause a detriment to the company.

Liquidators may sue the directors for recovery of loss and damage suffered by the company as a result of the breach of these duties. Breaches of the statutory duties may also give rise to civil penalties and, in extreme circumstances, can amount to a criminal offence.

- *Uncommercial transactions.* A company's uncommercial transaction of the company (which is assessed as uncommercial by reason of, among other factors, the benefits and detriment to the company of entering into it) 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 the company became insolvent as a result. The two-year period is extended to four years where the transaction involves a related entity.

  If the payment was entered into or given effect to after the deemed commencement of the winding up but before the actual winding up commenced (i.e. during administration or while the company is subject to a DOCA), and without the authority of the relevant administrator, the liquidator can seek to avoid the transaction without also proving the company was insolvent at the time.

- *Unfair preferences.* A liquidator may seek to recover payments made to unsecured creditors within a period of six months prior to the relation-back day, if:

  (i) Those unsecured creditors have been preferred over other unsecured creditors within that period; and

  (ii) If those payments were made at a time the company was insolvent or the company became insolvent as a result of making those payments. The six-month period is extended to four years where a payment involves a related entity.

  If the payment was made after the relation-back day, but before the actual winding up commenced (i.e. during administration or while the company is subject to a DOCA), and without the authority of the relevant administrator, the liquidator can recover the payment without also proving the company was insolvent at the time.

- *Unfair loans.* An unfair loan made to the company at any time on or before the winding up began is voidable on the application of the liquidator. A loan is considered unfair if the interest or charges on it are extortionate.

- *Transactions entered into for the purpose of defeating, delaying or interfering with rights of creditors.* A transaction entered into at a time the company is insolvent or becomes insolvent as a result is voidable on the application of the liquidator if it was entered into within ten years of the deemed commencement of the liquidation and the company became a party to the transactions for reasons including defeating, delaying or interfering with the rights of any or all of its creditors on a winding up.

- *Unreasonable director-related transactions.* Transactions are voidable on the application of the liquidator to the court if it can be established that the company entered into a transaction (including making a payment or disposing of assets):

(i) During a period of four years ending on the relation-back day or after the relation-back day but before the date the company was actually wound up, if it was entered into without the authority of the administrator or deed administrator;

(ii) With a director or close associate of the director; and

(iii) It may be expected that a person in the company's circumstances would not have entered into the transaction having regard to the benefits to the company, the detriment to the company and the respective benefits to the other parties.

- *Transactions with the intention of avoiding employee entitlements.* Transactions entered into for the purposes of avoiding or reducing payment to employees of their entitlements are prohibited and persons in contravention may be personally liable to compensate the company for any loss or damage that may result.

The last six of the clawback mechanisms discussed above are known as voidable transactions in the Corporations Act. If a court is satisfied that the transaction is voidable, it may make orders including those for the repayment of money or the retransfer of property.

Priority of Claims and Government Assistance for Employee Claims

In a winding up, all unsecured creditors with 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 claim, if the circumstances giving rise to their 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.

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 associated *Corporations Regulations*. If a proof of debt is rejected in whole or in part, there are appeal rights.

Secured creditors[16] are entitled to enforce their security interest during the winding up unless it is void as against the liquidator as a matter of law (e.g. if the security interest has not been perfected within the applicable statutory timeframes) or by reason of a court order. Accordingly, subject to the exception that follows, secured creditors will be paid in priority to all other debts to the extent of their security. 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.

Apart from secured creditors, specified priority debts and claims include, 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 the order for liquidation; and

- Specified employee entitlements which include wages, superannuation contributions, leave entitlements, injury compensation and retrenchment payment (although employee claims of directors and their spouses have only limited, capped priority).

The Corporations Act provides for an automatic set-off in winding up where a creditor has a claim it asserts against the company, and the company also has a 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 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.

[16] Certain third party owners of personal property (such as suppliers under hire purchase agreements or under retention of title terms) are treated as secured creditors by reason of the *Personal Property Securities Act 2009*.

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 in respect of their claim.

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).

If a third person advances money to the company for the purpose of making a payment to employees in respect of priority entitlements, and that money is applied for that purpose, that person has the same right of priority in respect of the money advanced as the employees would have had in the liquidation had the employees not been paid.

In Australia, the government has established assistance schemes – the General Employee Entitlement and Redundancy Scheme ("**GEERS**")[17] and the Fair Entitlements Guarantee ("**FEG**")[18] – under which employees may be eligible to receive a payment from the Commonwealth Government in respect of specified entitlements up to a maximum amount, if those employees have lost their employment as a result of the insolvency of their employer. GEERS/FEG (as applicable) will then seek to recover those payments in the winding up of the insolvent employer and will have the same priority of payment that the employees would have had in the liquidation had the employees not been paid under GEERS/FEG.

Receivership

A receiver may be appointed to a company either by a secured creditor (a "**private receivership**") or, in exceptional circumstances, by the court (a "**court-appointed receiver**"). This summary only discusses private receiverships.

A receiver is appointed by a secured creditor (commonly a lender) pursuant to a security agreement (ordinarily after the company defaults under the security agreement) with powers to manage, preserve and realise enough of the company's assets covered by the security in order to discharge the outstanding debt owed to the secured creditor.

The powers of receivers are set out in the security agreement, often called a charge, and the Corporations Act. If the receiver is given the power to manage the affairs of the company in addition to these powers, the receiver will be referred to as a receiver and manager. Receivers are also referred to in the Corporations Act as "Controllers", a concept that includes mortgagees in possession.

Usually, receiverships will not have any court involvement.

A secured creditor may have a security interest over a company's circulating assets (e.g. over cash or trading stock), non-circulating assets (e.g. over equipment) or both.[19] When distributing proceeds of circulating assets, a receiver is obliged under the Corporations Act to pay certain priority employee entitlements claims first before paying the secured creditor.

Once the secured creditor has been paid in full, the receivership terminates.

---

[17] GEERS applies to bankruptcies and liquidations which commenced prior to 4 December 2012.

[18] FEG applies to bankruptcies and liquidations which commenced on or after 5 December 2012.

[19] The new legislative regime comprised in the *Personal Property Securities Act 2009* ("**PPSA**") commenced on 30 January 2012 and applies to security interests in personal property (as opposed to real property). Amongst other things, it replaces the former concepts of fixed and floating charges with security over circulating and non-circulating assets. However, under the PPSA, a security interest over non-circulating assets is the functional equivalent of the former fixed charge and a security interest over circulating assets is the functional equivalent of the former floating charge.

Conclusions and Additional Observations

Since the voluntary administration regime was introduced in Australia in 1993, it has become the most common formal corporate insolvency mechanism, by reason of its relative speed of implementation and the flexibility of outcome. However, we are seeing a resurgence of creditors' schemes of arrangement in complex restructurings, and in insolvency scenarios where a third party contributing funds for the benefit of creditors requires releases from those creditors.

There are some features of the Australian corporate insolvency landscape that warrant noting:

- *Directors' personal liability for insolvent trading as discussed above under the heading "Clawback and Recovery Mechanisms".* This feature of the Corporations Act is not found in most other insolvency regimes. Directors can also be personally liable for certain unpaid company taxes including the superannuation guarantee charge and to reimburse the Commissioner of Taxation if company tax payments are disgorged as unfair preferences. These potential personal liabilities will often motivate directors to act early to appoint a voluntary administrator and are often criticised as they are perceived to thwart restructuring attempts. Recently, the Australian Government has again raised the possibility of a "safe harbor" defence or carve out being inserted into the Corporations Act.[20] The proposed 'safe harbour' defence/carve out would seek to protect directors from personal liability for insolvent trading if they take certain steps to turn around the company (for example, by appointing a restructuring adviser to develop a turnaround plan for the company). As at the date of publication, a consultation process is underway in relation to these proposals.

- *Status of shareholder claims after the* Sons of Gwalia *decision*. Prior to the decision of the High Court of Australia in *Sons of Gwalia Ltd v Margaretic*[21] ("***Sons of Gwalia***"), it was generally accepted that claims of shareholders of companies in external administration that arose by virtue of their shareholding were claims in their capacity as members of the company rather than creditors. Under the Corporations Act, claims of members against the company are postponed until all other creditors have been paid in full. However, in *Sons of Gwalia*, the High Court determined that shareholders' claims do rank with the claims of unsecured creditors, where the claims arise from alleged misleading or deceptive conduct by the company on which the shareholders relied in purchasing the shares. The Australian Government subsequently passed legislation which reverses the High Court's decision in Sons of Gwalia and ensures that these types of claims by shareholders are subordinated to the claims of other creditors.[22]

- *Cross-border insolvency.* Australia adopted the UNCITRAL Model Law in the *Cross-Border Insolvency Act 2008*.

- *Ipso facto clauses*. Clauses in contracts that terminate or amend the contract by reason of an "insolvency event" occurring are generally enforceable under Australian law. However, the Australian Government has recently proposed introducing legislation which would have the effect of making such clauses void except in certain types of financial contracts, such as swaps. As at the date of publication, a consultation process is underway in relation to this proposal.[23]

[20] The proposal was made as part of the "Improving bankruptcy and insolvency laws" proposals paper released on 29 April 2016.

[21] (2007) 232 ALR 232.

[22] See s 563A of the Corporations Act, effective from 18 December 2010.

[23] The proposal was made as part of the "Improving bankruptcy and insolvency laws" proposals paper released on 29 April 2016

Australia

Baker & McKenzie
Level 19
181 William Street
Melbourne VIC 3000
Australia

T + 61 3 9617 4200
F + 61 3 9614 2103

Baker & McKenzie
Level 27 AMP Centre
50 Bridge Street
Sydney NSW 2000
Australia

T + 61 2 9225 0200
F + 61 2 9225 1595