

mortgage) will normally grant the secured creditor the ability to appoint a receiver. Once appointed, the receiver will realise the company's assets solely for the benefit of the secured creditor to the exclusion of the rest of the company's creditors. A creditor may also exercise rights as mortgagee in possession and take control of the property with a view to realising value.

Retention of title clauses are another way a creditor may enforce proprietary and contractual rights outside court proceedings. If effective, this will allow the creditor to reclaim property supplied to the company in the event of the company's receivership, administration or liquidation. Retention of title clauses fall within the definition of 'security interest' under the Personal Property Securities Act 2009 (Cth) (PPSA) and are therefore required to be registered under the provisions of the PPSA. A traditional retention of title arrangement will be considered a 'purchase money security interest' under the PPSA, and, upon registration, will give the holder priority over other registrable interests. In this sense, while the requirements for enforcing a retention of title clause will change, the effect shall remain the same.

A number of common law and statutory liens are also available (and do not require registration under the PPSA).

Unsecured credit

A creditor may commence proceedings through the courts to recover outstanding amounts owing by a recalcitrant debtor company. A creditor, at the same time, may also request that the court order injunctive relief to freeze the assets of the company if there is a risk of assets or value being dissipated. A failure to plead a substantive defence will generally enable a default judgment to be granted and the creditor may, after this, take steps to wind the debtor company up.

The court has extensive powers to compel compliance and enforce a range of remedies including seizure of assets, diversion of a debtor company's income and orders for winding up of the company. Foreign creditors may be required to provide security for costs (ie, a sum of cash to the courts) of enforcing a judgment in Australia.

The options available to unsecured creditors of an insolvent company or company in distress are limited. Once a company is placed into administration or liquidation, a statutory moratorium will apply to any proceedings commenced, including any enforcement proceedings.

Creditor involvement and proving claims

Notice of the appointment of an administrator must be lodged with the Australian Securities and Investments Commission (ASIC) within one day and creditors must be notified of the appointment within three days.

The administrator must convene a meeting of creditors within eight business days of his or her appointment. Notice of this meeting must be given in writing to as many creditors as is reasonably practicable at least five business days before the meeting and published on ASIC's insolvency notices website. At this meeting, creditors have the opportunity to appoint a different administrator and may also decide whether to appoint a consultative committee of creditors to assist the administrator. Although the committee cannot give directions to the administrator, it can compel the administrator to report on matters relating to the administration. The committee is also in a fiduciary relationship with the creditors and thus cannot profit from their role.

The second creditors' meeting must be convened by the administrator within five business days after the convening period. The convening period is 20 business days from the date the administration begins, and the same notice requirements apply. This is extended to 25 business days if the administration begins in December or occurred less than 25 days before Good Friday. The notice of the meeting must be accompanied by a report setting out the company's business, property, affairs and financial circumstances and a statement expressing the administrators' opinion on each of the options available to the creditors (executing a deed of company arrangement (DOCA), returning control of the company to the directors or winding up the company). If the administrator proposes a DOCA, details of the proposed DOCA must also be provided. At the meeting, the creditors decide and vote on which of the three available options they wish to pursue. The administrator presides at both the first and second meetings.

The reporting obligations of an administrator include the following:

lodge notice of appointment with ASIC by the next business day following appointment, and publish on ASIC's insolvency notices website within three business days;

prepare and lodge a report with ASIC where it is suspected that an officer, employee or member of the company has committed an offence in relation to the company; and

where the creditors vote to wind up the company, to lodge a copy of that resolution with ASIC within five business days of it being passed.

In a creditors' winding up, no meetings of creditors are automatically held. A liquidator must hold a meeting if requested by a creditor with a minimum percentage of overall debt by value and if the liquidator considers

property to hold the meeting, a meeting of creditors dealing with the same matters has been held or will be held within 15 business days, or if the request is vexatious.

A liquidator must send to creditors:

within 10 business days of their appointment, notice of their appointment, information about creditors' rights, and a summary of the company's affairs and information about the company's creditors;

within three months of their appointment, a statutory report that includes information about the estimated assets and liabilities of the company, inquiries undertaken and to be undertaken by the liquidators, the likelihood of receiving an interim dividend and possible recovery actions; and

any other reports the liquidator decides or that are reasonably requested by creditors.

These notices and reports must be lodged with ASIC.

During a receivership, there is no obligation to call a creditors' meeting but notice of the appointment must be lodged with ASIC. Reports must be lodged with ASIC during the receivership and notification must be given on its termination.

Creditors of a company in administration or liquidation have a right to request information at any time. An administrator or liquidator must provide the information required if the information is relevant to the administration or liquidation, the provision of the information would not cause the administrator or liquidator to breach their duties, and if the request is reasonable. A request for information would not be reasonable if complying with the request would prejudice the interests of one or more creditors or a third party, if the information is the subject of client legal privilege or disclosure would be actionable for breach of confidence, if the request is vexatious, if there is not sufficient property to comply with the request, or the information has already been provided or is required to be provided within 20 business days of the request. In relation to the last three reasons, the administrator or liquidator will still have to provide the information if the creditor meets the cost of complying with the request.

Creditor representation

Committees in the Australian insolvency regime are creatures of statute and are not seen in the context of representing creditor stakeholder groups as they might be in the United States.

In such a case, the liquidator must call separate meetings of creditors and members for the purpose of determining whether a committee of inspection should be appointed and, if a committee is to be appointed, the numbers of creditors and members to be appointed and the persons who are to be members of the committee.

In a voluntary administration, a committee of inspection may be formed at the first creditors' meeting.

The role of the committee of inspection is to supervise and assist the administrator or liquidator. Examples of the types of direction the committee may make include approving the remuneration of the administrator or liquidator, approving the institution of legal proceedings on behalf of the company, and directions as to the compromise of debts owing to the company. Committees of inspection are most often used in large liquidations or administrations where it is difficult for the liquidator to engage with the entire body of creditors on a regular basis.

The committee must have at least two members, drawn from the body of creditors and members. A company can be a member, acting through an authorised agent. Generally, the members of the committee of inspection will comprise those with a substantial interest in the winding up of the company, such as large creditors, employees and members holding a large proportion of the company's shares.

The administrator or liquidator of the company must have regard to the directions of the committee but is not required to comply with these directions.

Members of the committee of inspection owe the general body of creditors and members fiduciary duties and therefore must act in the best interests of the creditors and members rather than for their own benefit.

There is no statutory provision governing the remuneration of the committee of inspection. Except with leave of the court, a committee member may not derive any income from their position. They also must not become the purchaser of any property of the company.

It is almost unheard of for such committees to retain counsel and advisers.

Enforcement of estate's rights

An administrator, liquidator or provisional liquidator can sell or otherwise dispose of, in any manner, all or any part of the property of the company. As a claim available to an estate forms part of the company's property, a liquidator may assign the claim to a creditor for consideration. The beneficiary of the 'fruits of

be pursued for the benefit of all creditors. In such circumstances, the creditors providing the indemnity or funding may be entitled to receive a higher dividend than they would otherwise receive by operation of section 564 of the Corporations Act 2001 (Cth).

In addition to administrators' and liquidators' power to assign causes of action, third-party litigation funding has been increasing in acceptability and prevalence since the endorsement of the practice in the non-insolvency context by the High Court of Australia in *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 CLR 386. This has brought with it increased access to litigation funding for liquidators and administrators.

Claims



A liquidator will notify creditors of the submission date and may do so by advertising it in a newspaper and also on the centralised insolvency notice website. This date may not be less than 14 days after the date of notice being given to creditors. Once the particulars of a debt are submitted by a creditor, the liquidator may admit:

all or part of the claim;

reject all or part of the claim; or

require further evidence to be submitted in support of it.

If further evidence is required, the liquidator must notify every creditor in writing of the day on which the formal proof must be submitted. A liquidator must deal with submitted formal proof of claims within 28 days of receipt.

Where a proof of debt is rejected by a liquidator, grounds for the rejection must be provided to the creditor within seven days. A creditor can appeal the liquidator's decision in court within the time specified in the notice (at least 14 days after service).

It is possible for a creditor's claim to be assigned in writing. An assignee may apply to the liquidator and the court to have its new proof of debt stand as substituted for the assignor's proof of debt. Such an assignee will be able to enforce the full value of the claim irrespective of whether it was acquired at a discount (ie, below par).

date of winding up or refer the question to the court for judicial consideration.

A creditor aggrieved with the estimate made by the liquidator may appeal to the court. If the contingent event occurs after the date of winding up, the creditor is entitled to prove for the actual amount of the claim.

A creditor can claim for interest accrued after the opening of the insolvency case and there is a prescribed rate in the Act of 8 per cent. Payment of this interest will rank behind all other claims (except subordinated equity claims).

In attempts to counter illegal phoenixing, amendments were made to the Insolvency Practice Rules (Corporations) Amendment (Restricting Related Creditor Voting Rights) Rules 2018 (the Amending Rules) to prevent the 'stacking' of related creditor votes and, accordingly, the ability for phoenix operators to control the appointment and replacement of an external administrator of a company.



The Amending Rules introduced two principal amendments to the Insolvency Practice Rules:

the insertion of 75-95(1A) providing a requirement for an external administrator to ask any creditor voting an assigned debt for evidence of the debt and the consideration for the assignment; and

the insertion of 75-110(7) providing a regime by which the value of any related creditor vote of an assigned debt is to be calculated as the value of the consideration given for the assignment.

Accordingly, where the consideration given by a related creditor for the assigned debt is less than the value of the debt, the value of the vote will be limited to the consideration given and not the full value of the debt. As such, external administrators are positively required to call for appropriate evidence of assigned debts and appropriately calculate the value of assigned debts for voting purposes.

Set-off and netting

Set-off refers to the right of a creditor to plead a debt due from the debtor as a defence to all or part of the debtor's claim made against it. Section 553C of the Act provides that statutory set-off is available in a liquidation scenario where there have been mutual dealings between the distressed company and the relevant creditor. In such circumstances, an automatic account is taken of the sum due from one party to the other in respect of those mutual dealings and the sum due from the one is to be set off against any sum due from the other.

preference over the general body of creditors. Only creditors that choose not to rely on their security may take advantage of the rule.

A creditor is, however, unable to claim the benefit of set-off if he or she had, at the time of the relevant transaction, notice of insolvency of the company. Further, a creditor cannot offset any existing claim or debt of the company against new claims or debts that may arise during the period of administration.

In other reorganisations, there is no statutory right of set-off and the creditor must rely on any contractual rights they may have. Those rights will be subject to a statutory lien that has attached to the company's property at the time that the set-off is made. In practice, however, administrators and deed administrators will ordinarily recognise set off as if section 553C did apply, as generally creditors can claim prejudicial treatment if they receive less from administrators or under DOCA's than they would under a liquidation scenario (and often wording similar to section 553C is built into a DOCA).



Modifying creditors' rights

Generally speaking, unsecured claims rank *pari passu* (with some exceptions), with secured creditors afforded a level of priority by virtue of the security arrangements in place.

The court has power to change the rank of a creditor's claim in only very limited circumstances. Section 564 of the Act provides an incentive to creditors to give financial assistance or indemnities to liquidators to pursue asset recovery proceedings or to protect or preserve property. If creditors provide such assistance, the liquidator may apply to the court for an order that the contributing creditors receive a higher dividend from the company's assets than they would otherwise be entitled to.

In assessing any claim under section 564, the court will consider all the circumstances surrounding the claim. Therefore, it is difficult to assess the frequency and likelihood of success attributable to any individual claim. The courts, in exercising their discretion, will have particular regard to factors such as the amount of risk to creditors, the amount recovered and the proportion between the debts of participating creditors and others, as well as the public interest in encouraging creditors to provide indemnities to enable assets to be recovered. Litigation funding can also be obtained outside the court process.

A DOCA may determine the creditors to be paid and how much they are to be paid (noting that a level of protection is afforded to employees unless they agree otherwise). Aggrieved creditors can apply to the court to overturn a DOCA if they are discriminated against.

Priority claims

liquidator in realising the assets of the company and in carrying on the company's business and the costs in relation to any applications to the court in respect of the winding up and employee-related entitlements.

A company's debts to the Commonwealth government do not receive any special priority. Amounts in respect of unpaid income tax rank as unsecured debts and are payable only if there are sufficient funds left over after all preferential debts have been paid.

Certain employee entitlement claims will have priority over secured debts, which are secured by a security interest of circulating assets (ie, receivables and stock, etc).

Employment-related liabilities



Outstanding employees' wages, superannuation, leave entitlements and redundancy payments are given priority over payment of ordinary unsecured creditors in the distribution of assets in the winding up. Pursuant to the Commonwealth's Fair Entitlement Guarantee (FEG), when a company is placed into liquidation leaving employee entitlements unpaid, the Commonwealth government, through FEG, can make payments to employees of certain levels of unpaid wages, leave and other entitlements. The Commonwealth then becomes a creditor of the company and is afforded the same priority in the distribution as the employee claims it paid.

Upon the making of a winding-up order by the court, the publication of that order acts as a notice of dismissal of all employees of the company. An employee who was engaged subject to a contract of employment for a fixed term, or was entitled by his or her contract of employment to a period of notice before termination of the contract, may lodge a proof of debt for damages for breach of contract. While the appointment of a voluntary liquidator does not necessarily operate as a notice of dismissal, the liquidator has the power to terminate contracts of employment.

In relation to a company in administration and receivership, upon appointment, the administrator or receiver takes control of the company's business, property and affairs. The retention of employees will depend upon the outcome of the administration process. If the business continues to operate, employees may be retained. An administrator and receiver can also terminate employment contracts in the same way as management of the company could when the company was operating as a going concern.

The Act affords a level of protection to employee entitlements following the company and its creditors entering into a DOCA. The Act provides that the entitlements of employees be given certain priorities in a deed, those priorities to be at least equal to what they would receive if the company were being wound up.

Employee entitlements are afforded a level of priority in liquidations, receiverships and administrations. Under section 556 of the Act, employee entitlement claims are afforded a level of priority over other unsecured claims (noting that expenses of the liquidation still rank higher). A cap applies to the level of employee entitlements that are afforded priority for former officers of the company. In a receivership, employee entitlements are afforded priority over secured claims that are only secured by a security interest of circulating assets (the old floating charge).

A claim for unpaid employee entitlements is lodged in the same manner as other unsecured claims (ie, a proof of debt in the ordinary course). A statutory regime also exists (FEG) to supplement amounts available for employee claims.

Where there is unpaid superannuation in an insolvency, a super guarantee charge (SGC) is required to be paid before payments are made to ordinary unsecured creditors. This is an incurred penalty charge administered to employees owing to a failure to pay an employee's minimum superannuation guarantee on time and to the correct fund. SGC payments are ranked equally with employees' entitlement to wages and super contributions in circumstances where there are assets available for distribution to priority creditors. Priority SGC claims for excluded employees, such as directors and their spouses, are capped at A\$2,000 and any amounts exceeding A\$2,000 will rank *pari passu* with other unsecured claims.

Further, DOCA's are required to include a clause to the effect that eligible employee creditors will enjoy a priority under the administration, which is at least equal to what they would have received had there been a winding up.

Environmental problems and liabilities

Ultimate responsibility for any environmental issues will continue to rest with the relevant distressed debtor company. Upon appointment, an insolvency administrator will not automatically assume responsibility for these liabilities but will need to be aware of any such concerns and damage should they seek to continue to trade the company. Should further damage accrue during the course of the insolvency administrator trading the business, they may be held liable in the same way that directors have been held liable pre-appointment. Further, in scenarios where the insolvency administrator seeks to sell or realise the relevant asset, engagement with the environmental regulator will be required where there is pre-existing environmental damage and often remediation will be a contractual condition to the sale.

Creditors will not be held liable for controlling or remediating any environmental damage. The debtor's officers and directors could potentially be held liable for such liabilities in circumstances where the company enters formal liquidation and it can be shown the company was cash-flow insolvent at the time

Liabilities that survive insolvency or reorganisation proceedings

The liabilities of a corporate debtor do not subsist after a liquidation has concluded. Under either a voluntary or involuntary arrangement, the creditors will receive compensation from the company's assets in proportion to the debts owing to them in satisfaction of their claims. The company's debts will be discharged in the context of these restructuring proceedings and thus the creditors' claims will not subsist after winding up. Upon deregistration, a company will cease to exist as a corporate entity and any surplus assets will vest in the corporate regulator.

Unsecured claims subsist after a receivership has concluded and such creditors may bring an action against the company (noting they are unlikely to do so unless significant assets remain). The outcome of the second creditors' meeting during a voluntary administration will determine what creditors' claims subsist (ie, either a DOCA or winding up is likely to commence).

Under a scheme of arrangement, those creditors whose rights are not compromised or affected will continue to have their original claim against the company.

Distributions

In liquidation, distribution will occur when funds are available. Under a DOCA or a scheme of arrangement, the distribution arrangements are generally set out in the terms of the respective instruments. It is possible for interim distributions to be made as funds become available.

Security

Secured lending and credit (immovables)

The principal type of security that is taken on real property in Australia is a mortgage, for which a registration system exists (referred to as the Torrens Title system). Under this system, a mortgagor who has registered a mortgage with the relevant state or territory land title register grants a legal charge over the land as opposed to transferring legal title to the mortgagee. The mortgagor and mortgagee thereafter both possess a legal interest in the land. The mortgagor is free to deal with the land (subject to any restrictions in the terms of the mortgage itself) and retains the beneficial and legal interest in the land. The mortgagee holds a legal charge that will confer actionable rights in the event of default by the mortgagor.

written agreement) to enter into one or the mortgagor deposits the title deeds with the mortgagee.

Secured lending and credit (movables)

In 2012, the Personal Property Securities Act 2009 (PPSA) came into force in Australia, modelled largely on equivalent legislation in New Zealand and Canada. This legislation consolidated all of the existing registers on which security interests were previously registered and amended many of the concepts and terms associated with taking security over assets.

The PPSA introduced a uniform concept of a 'security interest' to cover all existing forms of security interests, including mortgages, charges, pledges and liens. It applies primarily to security interests under which an interest in personal property is granted pursuant to a consensual transaction that, in substance, secures payment or performance of an obligation. It also applies to certain deemed security interests such as certain types of lease arrangement for certain terms, retention of title arrangements and transfers of debts, regardless of whether the relevant arrangement secures payment or performance of an obligation. 'Personal property' is broadly defined and essentially includes all property other than land, fixtures and buildings attached to land, water rights and certain statutory licences.

The legislation has introduced a new lexicon relating to security in Australia. For instance, the traditional concept of a fixed and floating charge has now been replaced by 'general security agreement' and the PPSA now determines whether an asset is, in effect, subject to a floating charge on the basis that only circulating assets, as defined by the PPSA, will be treated as being subject to a floating charge for the purposes of other legislation including the provisions of the Corporations Act 2001 (Cth) that provide priority of certain claims over floating charge assets. Generally, attachment and perfection of a security interest occurs when the grantor and the secured party execute a security agreement, although the parties can defer attachment, and the security interest is registered on the PPSA register. However, security interests over certain assets can be perfected other than by way of registration; for example, by the security holder controlling the relevant asset in the manner prescribed by the PPSA.

The concept of security interest is broad enough to capture pre-existing forms of security and the documentation creating security has not changed significantly (ie, charges, debentures, mortgages and pledges may still be used with certain amendments).

One of the most significant changes implemented by the PPSA is to require the registration of retention of title arrangements to protect a supplier's title to the relevant supplied goods.

failure to perfect the retention of title arrangement (by registration) will vest title in the relevant goods in the recipient of the goods, despite the agreement between supplier and recipient that the supplier retains title to those goods until they are paid for.

The PPSA does not cover security interests in land or fixtures and buildings attached to land. A mortgage over real property must be registered under the Torrens Title system, which operates under Australian law by registration on the relevant state or territory land title register. There are also certain assets such as statutory licences (eg, mining licences), which, by virtue of statute, are expressed to be outside the operation of the PPSA, and any security interest over any such asset is governed by common law.

Clawback and related-party transactions



Transactions that may be annulled

The following types of transactions may be held to be void and set aside after a company has entered into liquidation:

insolvent transactions (which includes both unfair preferences and uncommercial transactions); unfair loans;

unreasonable director-related transactions; and

transactions entered into for the purpose of defeating, delaying or interfering with creditors' rights on a company's winding up.

Uncommercial transactions and unfair preferences are voidable if the company was insolvent at the time of the transaction or at a time when an act was done to give effect to the transaction. To be set aside, the relevant transaction must have been entered into or given effect to within two years of the 'relation back day' (being the commencement of the winding up or in certain circumstances the date when an administrator was appointed). The courts have held a transaction 'uncommercial' if a reasonable person in the company's circumstances would not have entered into it. An unfair preference is one where a creditor receives more for an unsecured debt than would have been received if the creditor had to prove for it in the winding up. The other party to the transaction or preference may prevent it from being held void if it can be shown that they became a party in good faith, they lacked reasonable grounds for suspecting that the company was insolvent and they provided valuable consideration or changed their position in reliance on

Loans to a company are 'unfair' and thus voidable if the interest or charges in relation to the loan were, or are, not commercially reasonable. Any 'unreasonable' payments made to a director or a close associate of a director are also voidable, regardless of whether the payment occurred when the company was insolvent.

A liquidator can seek a court order under section 588FF of the Corporations Act 2001 (Cth) (the Act) with respect to suspected voidable transactions. Such orders must be sought within three years of the relevant 'relation back day' or within 12 months after the first appointment of a liquidator (whichever is later).

Potential orders include the repayment of money paid or retransfer to the company of property it transferred. Orders may also be made varying a contract that is part of the transaction.

A liquidator can also apply to set aside 'creditor-defeating' transactions. Section 588FE(6B) of the Act enables liquidators to apply to set aside dispositions of property where the relevant transaction (or act done to effect the transaction) was entered into while the debtor company was insolvent, caused the debtor company to become insolvent or, directly or indirectly, resulted in the debtor company entering into external administration. The term 'Creditor-defeating dispositions' is defined in section 588FDB of the Act as a disposition where the consideration payable for the disposition was less than either the market value or the best price reasonably obtainable in the circumstances, and where the disposition has the effect of preventing, hindering or significantly delaying the process for the property becoming available for the benefit of creditors in the winding up.

In 2019, various amendments to the Act were introduced to enhance recovery measures for employee entitlements, namely:

- an extension of the previous criminal offence provision to capture a person recklessly entering into transactions to avoid the recovery of employee entitlements;

- a new civil offence for such action with an objective reasonable person test; and

- an ability for a liquidator, among others in certain circumstances, to seek compensation for loss or damage suffered because of a contravention of the civil penalty provision.

Equitable subordination

No. However, related party claims are likely to be subject to greater scrutiny.

Generally, lenders will not be held liable for the debts owed by an insolvent debtor. However, in certain circumstances, lenders working closely with a borrower (eg, lenders guiding a borrower in an effort to protect their debt exposure) may be considered 'de facto' or 'shadow' directors for the purposes of the Act and, therefore, exposed to liabilities associated with an insolvent debtor. A person may be held to be a de facto or shadow director of a company where, despite not holding an officer role in the company, they are a person in accordance with whose instructions and wishes others are accustomed to act (as detailed in the expanded definition of 'director' in section 9 of the Act). Such circumstances, for example, could expose a lender or their directors to liability for insolvent trading and other breach of directors' duties claims.

The New South Wales Court of Appeal considered this issue in the decision of *Buzzle Operations Pty Ltd (in liquidation) v Apple Computer Australia Pty Ltd* [2011] NSWCA 109. In that case, while the Court did not find that the relevant persons were acting as shadow directors (and therefore were not liable for insolvent trading claims), it did consider that for a person to be considered a shadow director, something more than mere control is needed: the decision-making must be deferred to the relevant persons such that the existing directors follow the instructions of the purported shadow director because those instructions are themselves treated as a sufficient reason to act. That is, a secured creditor will not be taken to be acting as a shadow director merely because they influence decisions by virtue of any leverage concerning their secured interests. Rather, others must be accustomed to acting in accordance with their instructions in a general sense (eg, even if those instructions are contrary to the interests of the company).



Groups of companies

Groups of companies

Cross-collateralisation and group guarantees are often sought by lenders into a corporate group. These guarantees provide comfort that a holding company will stand behind special purpose vehicles or operating companies. There is also a statutory form of cross-guarantee lodged with the Australian Securities and Investments Commission allowing corporate groups to lodge consolidated financial statements. This statutory cross-guarantee provides for a group to be liable for each other group member's debts and is designed to afford a level of comfort to creditors providing services or lending to operating subsidiaries. It also affords relief to corporate groups from the onerous reporting obligations imposed by Chapter 2M.3 of Corporations Act 2001 (Cth) (the Act). If certain requirements are met, the holding entity and its wholly owned entities will be considered a single legal entity for financial reporting purposes and will be able to prepare consolidated financial report. Corporations (Wholly-owned Companies) Instrument 2016/785 currently provides relief to wholly owned subsidiaries, provided:

the group executes the standard deed of cross guarantee form;

deed;

a lawyer has certified that the relevant deed's wording is in accordance with the ASIC pro forma; and the holding company prepares and lodges audited financial statements for the group as a whole.

Further, under section 588V of the Act, a holding company of a company may, in certain circumstances, be held liable for the insolvent trading of a subsidiary

Under the Act, a court can make a 'pooling order' such that in the liquidation of a group of companies each of the separate group companies are treated as if they were a single company. This means that the creditors of the group will have their claims 'pooled' so that, in effect, they are treated as creditors of one entity with a combined pool of assets for distribution.



Notwithstanding that the Act makes no provision for the pooling of assets and liabilities of a group of companies in administration, Australian courts have sanctioned the use of pooling arrangements for groups in administration proposing to execute a pooled deed of company arrangement (DOCA). Ultimately this will be a decision of the creditors voting; however, a pooled DOCA will be persuasive if the return creditors of the group as a whole will provide a greater return than if the individual entities ratified separate DOCAs or were placed into liquidation.

Combining parent and subsidiary proceedings

In insolvency proceedings involving corporate groups, a consolidated group is not considered as a single legal entity. Where companies operate as a consolidated group, the starting legal position is that the 'separate personality' principle prevents creditors of an insolvent company from gaining access to the funds of other companies for payment of their debts.

The Act, however, provides for a holding company to be liable for the debts of their insolvent subsidiaries in certain circumstances. These provisions enable the subsidiary's liquidator to recover amounts equal to the loss or damage suffered by creditors from the parent company if the parent failed to prevent the subsidiary from incurring debts while there were reasonable grounds to suspect that the subsidiary was insolvent.

The corporate veil may also be lifted in circumstances where an insolvent subsidiary is deemed to be acting as a mere agent, conduit or partner of its parent company. Australian courts have, however, displayed greater reluctance than their UK counterparts to lift the corporate veil in these circumstances.

must be made to the court requesting a meeting of the creditors and members. Where a scheme of arrangement is proposed involving a large corporate group, the application may request for the meeting to occur on a consolidated basis. An application for an order to transfer the whole of the assets and liabilities of the subsidiaries to the parent company may also be made when seeking approval of a proposed scheme.

This scheme requires significant court involvement and thus execution is generally slower and more expensive than voluntary administration.

Pooling of group funds may occur in limited circumstances, as prescribed by Division 8, Part 5.6 of the Act, being sections 571 to 579L. Generally, those circumstances are where there is a substantial joint business operation between members of the same corporate group and external parties, such that members of the group are jointly liable to creditors. The liquidator of the corporate group being wound up makes what is called a pooling determination, after which separate meetings of the unsecured creditors of each company must be called to approve or reject the determination. The court may vary or terminate any approved pooling determination.

A pooling order must satisfy all the requirements of section 579E of the Act. In forming a view, the court will often consider the operational realities of an insolvent group of companies; whether they are centrally managed, which entities are income-generating and what role is played by the parent entity. The court does not have power to make a pooling order if it will materially disadvantage an unsecured creditor, or if the possibility for disadvantage is not outweighed by the potential advantages of pooling assets.

In relation to a company in liquidation, the court may make orders for the transfer of assets from a winding up in Australia to an external administration outside Australia, either pursuant to section 581 of the Act or pursuant to the UNCITRAL Model Law on Cross-Border Insolvency, incorporated into Australian law by the Cross-Border Insolvency Act 2008 (Cth).

International cases

Recognition of foreign judgements

The Foreign Judgments Act 1991 (Cth) (FJA) creates a general system of registration of judgments obtained in foreign countries. The FJA only extends to judgments pronounced by courts in countries where, in the opinion of the governor general, substantial reciprocity of treatment will be accorded by that country in respect of the enforcement in that country of judgments of Australian courts. Judgments of other foreign countries may also be recognised under the common law rules for the recognition of foreign judgments.

has been taken, within six years of the last judgment in the appeal proceedings.

UNCITRAL Model Law

Australia formally adopted the UNCITRAL Model Law on Cross-Border Insolvency by implementing legislation called the Cross-Border Insolvency Act 2008 (Cth) (the Cross-Border Act).

This legislation adopts the UNCITRAL Model Law with as few changes as necessary to adapt it to the Australian context. Some of the most important features of the legislation include:

the participation by foreign creditors in local insolvency proceedings;

facilitated cooperation between courts and insolvency practitioners from different countries;

allowing a person administering a foreign insolvency proceeding to have access to local courts and in which circumstances this is possible;

the setting out of conditions for recognition of an insolvency proceeding and for granting relief to representatives of such a proceeding; and

the ability to effectively coordinate insolvency proceedings occurring concurrently in different states.



Foreign creditors

Under the Cross-Border Act, foreign creditors, save for tax and penal debts, have the same rights regarding the commencement of, and participation in, insolvency proceedings as an Australian creditor. All foreign claims must be converted into Australian currency for the purposes of the proceedings.

Cross-border transfers of assets under administration

In relation to a company in liquidation, the court may make orders for the transfer of assets from a winding up in Australia to an external administration outside Australia, either pursuant to section 581 of the Corporations Act 2001 (Cth) or the Cross-Border Act.

COMI

debtor's main interest is its registered office, or in the case of a natural person, his or her habitual residence.

The UNCITRAL Model Law is silent on the standard required for COMI determination.

Given this, the Australian courts have looked to and adopted similar reasoning to other jurisdictions when considering COMI (eg, the bankruptcy courts in the United States) and have equated the concept of COMI with the principal place of business. In considering where the COMI of a debtor or group of companies exists, the courts will look at a number of factors, including:

the location of the debtor's headquarters;

the location of those who actually manage the debtor; the location of the debtor's primary assets;

the location of the majority of the debtor's creditors or a majority of creditors who would be affected by the case; and

the jurisdiction whose law applies to most disputes.



Cross-border cooperation

Section 581 of the Act provides that an Australian court may request a foreign court with jurisdiction in external administration matters to render assistance in the recovery of overseas property of the company. In deciding whether to authorise a letter of request, one important consideration will be how likely it is that the foreign court will act upon the request.

The Cross-Border Act provides an alternative method whereby an Australian insolvency practitioner may seek recognition under the UNCITRAL Model Law in a foreign jurisdiction and thereby give the foreign court independent jurisdiction to provide assistance. Under the UNCITRAL Model Law, the insolvency practitioner may then have authority to recover assets in the foreign jurisdiction.

In relation to insolvency proceedings conducted in a foreign jurisdiction, section 581 of the Act also provides that an Australian court must assist bankruptcy courts of prescribed countries and has a discretion to assist courts of other countries. The prescribed countries are Canada, Jersey, Malaysia, New Zealand, Papua New Guinea, Singapore, Switzerland, the United Kingdom and the United States. Once again, the UNCITRAL Model Law provides an alternative procedure, whereby a representative in a foreign jurisdiction may approach an Australian court requesting assistance in the recovery of property located in Australia belonging to the foreign company. In *Re Cow Cho Poon (Private) Limited* (2011) 249 FLR 315, a Singaporean liquidator made an application to an Australian court pursuant to section 581 of the Act seeking

of utility and would aid the effectuation of the winding-up orders made by the Singapore court. It is likely that a similar result would have been reached had the UNCITRAL Model Law been invoked.

While in most cases Australian courts have formally recognised foreign proceedings under section 581 of the Act when requested to do so, there have been exceptions. For example, in *Yu v STX Pan Ocean Co Ltd (South Korea)*, in the matter of *STX Pan Ocean Co Ltd (receivers appointed in South Korea)* [2013] FCA 680, the court was reluctant to grant additional relief as the relief sought would adversely affect any rights that other Australian creditors may otherwise have had, whether under the Act or otherwise.

There is an example where an Australian court has refused to recognise foreign proceedings or grant relief sought under the Cross-Border Act in relation to a corporate insolvency. In *Indian Farmers Fertiliser Cooperative Ltd v Legend International Holdings Inc* (2016) 52 VR 1, the court refused to recognise US Chapter 11 proceedings in circumstances where the holding company's COMI was Australian (relevantly its assets and operations that were undertaken by its subsidiaries are all in Australia), and the company's US presence was purely administrative.



Cross-border insolvency protocols and joint court hearings

In January 2020, the Federal Court of Australia published the Cross Border Insolvency Practice Note: Cooperation with Foreign Courts of Foreign Representatives, which states that the court's cooperation obligation will be guided by the Guidelines for Communication and Co-operation between Courts in Cross-Border Insolvency Matters and the Modalities of Court-to-Court Communication (both published by the Judicial Insolvency Network), and the Practice Guide on Cross-Border Insolvency Co-operation 2009 (published by UNCITRAL).

Many of the cases involving cross-border elements heard in Australian courts involve the protection of assets and the issuance of injunctions or stay orders. One such example was the case of *Lawrence v Northern Crest investments Limited (in liq)* [2011] FCA 672, where an interim injunction was granted against the Australian directors of an insolvent New Zealand company restraining them from dealing with the company's assets, pending an application by the liquidator for orders that the winding-up proceedings in New Zealand be classified as a 'foreign main proceeding'.

The case of *Re Kelly, Halifax Investment Services Pty Ltd (in Liq) (No. 5)* [2019] FCA 1341 is a recent example of the Federal Court of Australia cooperating with the High Court of New Zealand to conduct a joint hearing of liquidators' application for directions.

Court of Australia was to be at least partially informed by the Guidelines for Communication and Co-operation between Courts in Cross-Border Insolvency Matters. Gleeson J granted the relief sought pursuant to section 581(4) of the Act, which provides that the Court may request a court of another country that has jurisdiction in external administration matters to act in aid of and be auxiliary to it in an external administration matter. The substantive hearing was subsequently heard jointly by the Federal Court of Australia and the High Court of New Zealand (being the first concurrent hearing between these two courts).

Winding-up of foreign companies

The rise of foreign investment in Australia has also seen a steady increase in the number of insolvencies of foreign companies in Australia. A foreign company that falls within the classification of a 'Part 5.7 body', that is, a foreign company that is registered under the Act or carrying on business in Australia, can be wound up under Australian insolvency processes. Once a foreign company carries on business in Australia, it is susceptible to a winding-up order, regardless of whether it has subsequently ceased to carry on business in the jurisdiction (see *Australian Securities and Investments Commission v Edward* [2004] QSC 344). Pursuant to section 583 of the Act, a Part 5.7 body can be wound up where it is unable to pay its debts, has been dissolved or deregistered, has ceased carrying on business in Australia or on just and equitable grounds. Largely mirroring the procedure for winding up an insolvent Australian company under Part 5.4 of the Act, the creditor is required to serve on the Part 5.7 body a statutory demand requiring payment of debt of at least A\$4,000 within 21 days. In response to the covid-19 pandemic, the Australian government made temporary changes to insolvency laws that included increasing the threshold amount for which creditors can issue a statutory demand (from what was then a minimum of A\$2,000 to A\$20,000) and the time for compliance of a statutory demand (from 21 days to six months). Following the expiry of these temporary changes on 31 December 2020, the Corporations Amendment (Statutory Minimum) Regulations 2021 amended regulation 5.4.01AAA of the Corporations Regulations 2001 (Cth) such that, from 1 July 2021, the statutory minimum amount for issuance of a creditor's statutory demand increased from \$2,000 to \$4,000 but the period within which a debtor must respond to a statutory demand remains at 21 days.

However, failure by a Part 5.7 body to pay the debt within the prescribed period does not result in an automatic presumption of insolvency (as is the case in a winding up under Parts 5.4 and 5.4B), but rather gives rise to a presumption that the company is unable to pay its debts (see *Cato Brand Partners Pty Ltd v Air India Limited* [2016] VSC 28). Where concurrent foreign and local liquidations are taking place regarding the same debtor and there is inconsistency between Part 5.7 of the Act and the UNCITRAL Model Law, section 22 of the Cross-Border Act dictates that the UNCITRAL Model Law prevails.

The Australian courts also have jurisdiction to order an ancillary liquidation where a foreign company registered in Australia is subject to a contemporaneous foreign liquidation. Section 601CL(14) of the Act

and Investments Commission, appoint an Australian liquidator of the foreign company. The powers of the Australian liquidator are limited, and unless the court otherwise orders, the net amount of all property of the foreign company recovered and realised by the Australian liquidator must be paid to the foreign liquidator.

Update and trends

Trends and reforms

On 28 September 2022, the federal government commenced an inquiry into the effectiveness of Australia's corporate insolvency laws in protecting and maximising value for the benefit of all interested parties. The investigating committee has noted that it recognises the need for Australia's corporate insolvency regime to be 'fit for purpose' and to 'effectively serve the Australian economy and all participants in it'. Accordingly, it has announced a broad review of recent and emerging trends in the use of corporate insolvency in Australia, including temporary covid-19 insolvency measures, and other policy measures introduced in response to the pandemic; and recent changes in domestic and international economic conditions, increases in material and input costs for businesses and inflationary pressures more broadly, and supply shortages in certain industries. Potential areas flagged for reform by the committee include the unfair preference regime, the treatment of trusts with corporate trustees as they relate to corporate insolvency, insolvent trading, safe harbour protection, and international approaches and developments. The committee is accepting submissions from interested persons and stakeholders up until 30 November 2022, with a view to submitting a report to both Houses of Parliament by 30 May 2023.

Recently, the courts have affirmed several long-standing principles and clarifying the position at law for practitioners.

For example, the High Court's decision in *Walton v ACN 004 410 833 Limited (formerly Arrium Limited)* (in liquidation) [2022] HCA 3 held that 'eligible applicants' (in this case, shareholders of failed companies) were entitled to summon former officers of those companies for public examination pursuant to section 596A of the Corporations Act 2001 (Cth) (the Act). The majority of the High Court held that public examinations under section 596A conducted for the purpose of obtaining evidence and information to support the commencement of proceedings against a company, its officers or advisers (and which was not for the ultimate benefit of the company or its creditors) is not an abuse of process. With that said, the Court retains its overarching jurisdiction to refuse an application for public examination if it considers that it would amount to an abuse of process.

Another separate example of the Court clarifying and affirming the position at law is in the case of *Morton as Liquidator of MJ Woodman Electrical Contractors Pty Ltd v Metal Manufacturers Pty Limited* [2021]

preference. The Court considered how the Act's unfair preference provisions interact with insolvency set-off under section 553C. Crucially, this included analysis of the requirement of 'mutuality'. That is, the claims that are sought to be set-off against one another must be between the same parties, and those parties must hold those claims for their own benefit and interest. Also relevant was the requirement that the liability being set off must already exist (even if in the form of a contingent liability) at the commencement of the liquidation.

Section 443B of the Act sets out the circumstances in which an administrator will be liable for payments for property used, occupied or in the possession of the relevant company during the administration period. Section 443B(2) provides that an administrator will be liable for rent and amounts payable under the relevant agreement that are attributable to the period commencing five business days after the administration begins (the grace period) and during which the company continues to use, occupy or possess the relevant property during the administration period.



The administrator may give notice before the end of the grace period stating they do not wish to continue to exercise rights in relation to the period. The effect of this notice is that, from the date of the notice until it is revoked, the administrator will not be liable for amounts owing under the relevant leasing arrangement for the period commencing after the grace period.

Section 443B(8) of the Act (together with the operations of the more general powers under section 447A of the Act) allows an administrator to apply to court to 'excuse' the administrator for any liability even where the notice was not given to the lessor before the expiry of the grace period. Also, an administrator may apply to court seeking to extend the grace period, in circumstances where:

further time is required to allow the administrators an opportunity to explore all options available to recapitalise or sell the company as a going concern, or to otherwise explore the possibility of entering into a deed of company arrangement (which includes deciding whether the company or administrators should continue to occupy the leased premises); and

the extension is in the best interests of the creditors as a whole.

The operation of section 443B only impacts the liability of the administrator. It does not affect the liability of the relevant company in administration.

In response to issues arising out of the covid-19 pandemic, there were three significant decisions regarding section 443B, each demonstrating the court's willingness to extend the grace period under section 443B in

First, in *Strawbridge (Administrator), in the matter of OBOH Group Pty Ltd (Administrators Appointed) (No. 2) [2020] FCA 472*, at the expiration of the grace period, the administrators elected to remain in possession of the relevant property and thereafter paid rent in accordance with the lease agreements that accrued after the grace period (with such payments forming part of the costs of the administration, and payments for which the administrators were personally liable). Subsequently - and as a result of the impact of the covid-19 pandemic - the administrators sought, and were granted, orders that they should not be personally liable for amounts due under the leases, notwithstanding that the company would continue to occupy and remain in possession of the property. Further, the administrators sought, and were granted, a declaration from the court that they would be justified in not causing the company to pay the amounts due even though the company remained liable for those amounts.



Second, in the administration of the Virgin Airlines group of companies (Virgin Group), the administrators applied for, and the court granted, orders modifying the time periods under sections 443B(2) and 443B(3) before the end of the grace period. The effect of the orders resulted in the Virgin Group administrators carrying on the Virgin Group's business with the benefit of an extension of the grace period in respect of certain liabilities for the administration period.

Third, in *Ford (Administrator, in the matter of The PAS Group Limited (Administrators Appointed) v Scentre Management Limited [2020] FCA 1023 (PAS Decision)*, the Federal Court of Australia considered the administrators' application for judicial directions as to whether rental amounts accruing during an administration period should be treated as a priority expense under section 556(1)(a) of the Act. Relevantly, the administrators previously sought, and were granted, an extension of the grace period under section 443B of the Act from the commencement of the administration (29 May 2020) until 22 June 2020. O'Callaghan J rejected the administrators' application, finding that by operation of the principle in *Lundy Granite*, the amounts payable under the lease arrangements during the extended grace period would be payable in a liquidation as a cost of the administration (that is, afforded priority under section 556(1)(a) of the Act). Having considered the parties' submissions and applying the principle in *Lundy Granite*, His Honour declined to make the order in circumstances where the administrators had actively traded from all but eight out of 161 leases, the administrators had 'elected to cause the company to continue in occupation of those leased premises for the purposes of the administration'.

On 3 May 2021, the federal government announced that it would consult with industry on improving schemes of arrangement to better support businesses, including by introducing a moratorium on creditor enforcement while

The consultation was aimed at assessing whether the current scheme of arrangement process is useful as a means of restructuring insolvent companies. In its current form, schemes of arrangement are typically used in complex restructurings of large corporate groups, involve a high level of court involvement and, unlike other insolvency processes (eg, voluntary administration), there is no automatic moratorium to prevent creditors from bringing claims against the company during the negotiation and formation of the scheme.

The federal government is considering the efficacy of introducing an automatic moratorium on creditor claims to provide 'breathing space' to financially distressed companies and what effect that could have on creditor rights. In particular, the consultation sought input from stakeholders as to:



whether an automatic moratorium should apply from the time a company proposes a scheme of arrangement; whether the moratorium applicable in a voluntary administration would be a suitable model on which to base the proposed moratorium for a scheme of arrangement, if any adjustments are required and if the court ought to be granted the power to modify or vary the moratorium;

when any moratorium should commence and terminate, and how long it should last;

whether any additional protections against liability for insolvent trading are required to support the proposed moratorium;

what safeguards are required to protect creditors that extend credit to the company during the automatic moratorium period; and

whether insolvency practitioners assisting with the scheme should be permitted to act as voluntary administrators of the company where the scheme fails.

The consultation also sought input on the efficacy of the current scheme of arrangement framework generally. As of 8 August 2022, there were 22 submissions from stakeholders, including advisers, industry bodies and insolvency practitioners.

In our view, the addition of a moratorium on creditor claims during the formulation of a scheme of arrangement is a welcome change and is likely to lead to higher uptake of the process by financially distressed (but still solvent) companies.

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**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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Contents

1	Introduction.....	ii
2	Voluntary administration	1
3	Creditors' schemes of arrangement.....	8
4	Receivership	10
5	Winding up in insolvency.....	14

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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 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.

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).

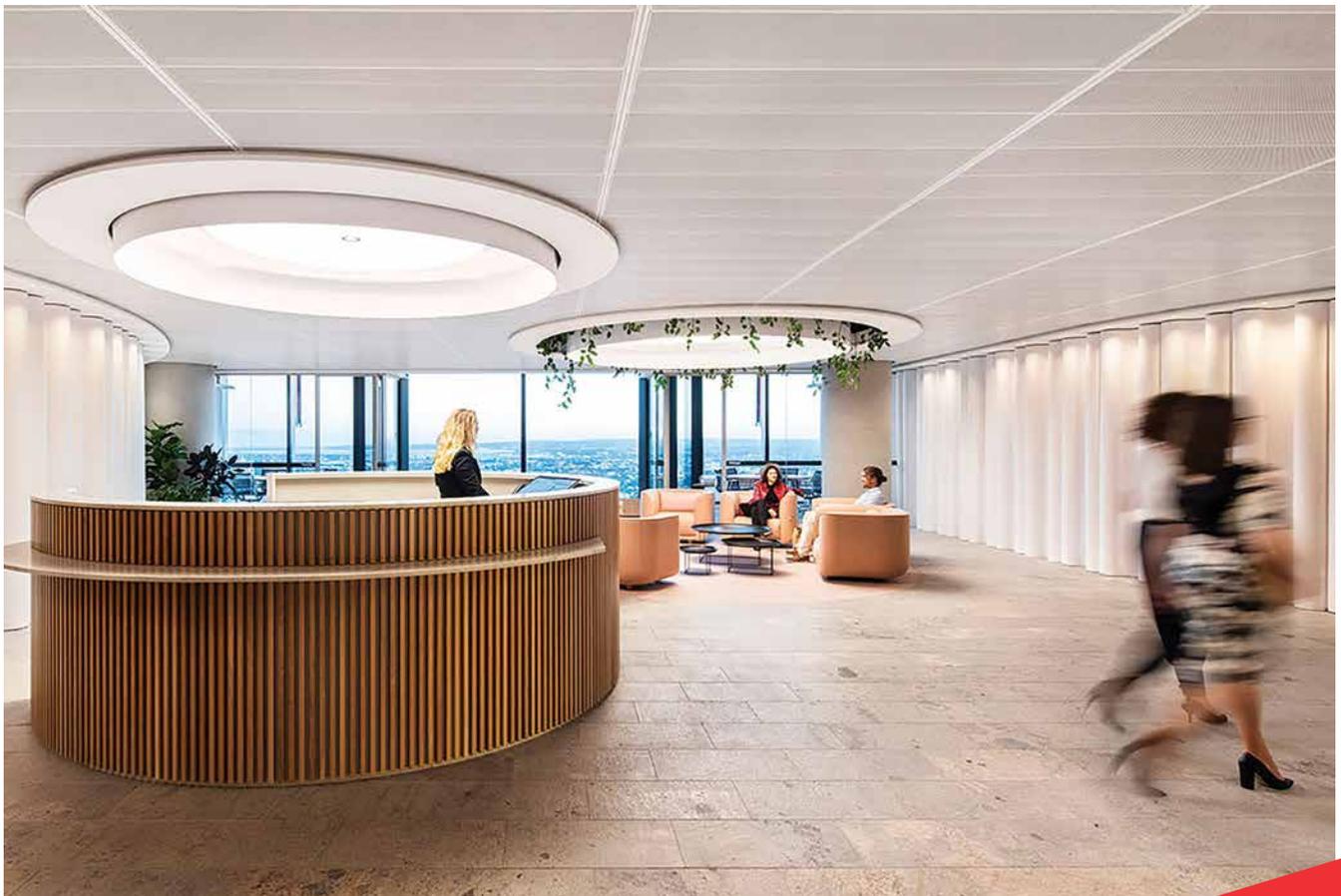
Commencement of voluntary administration

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 appointment² 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.



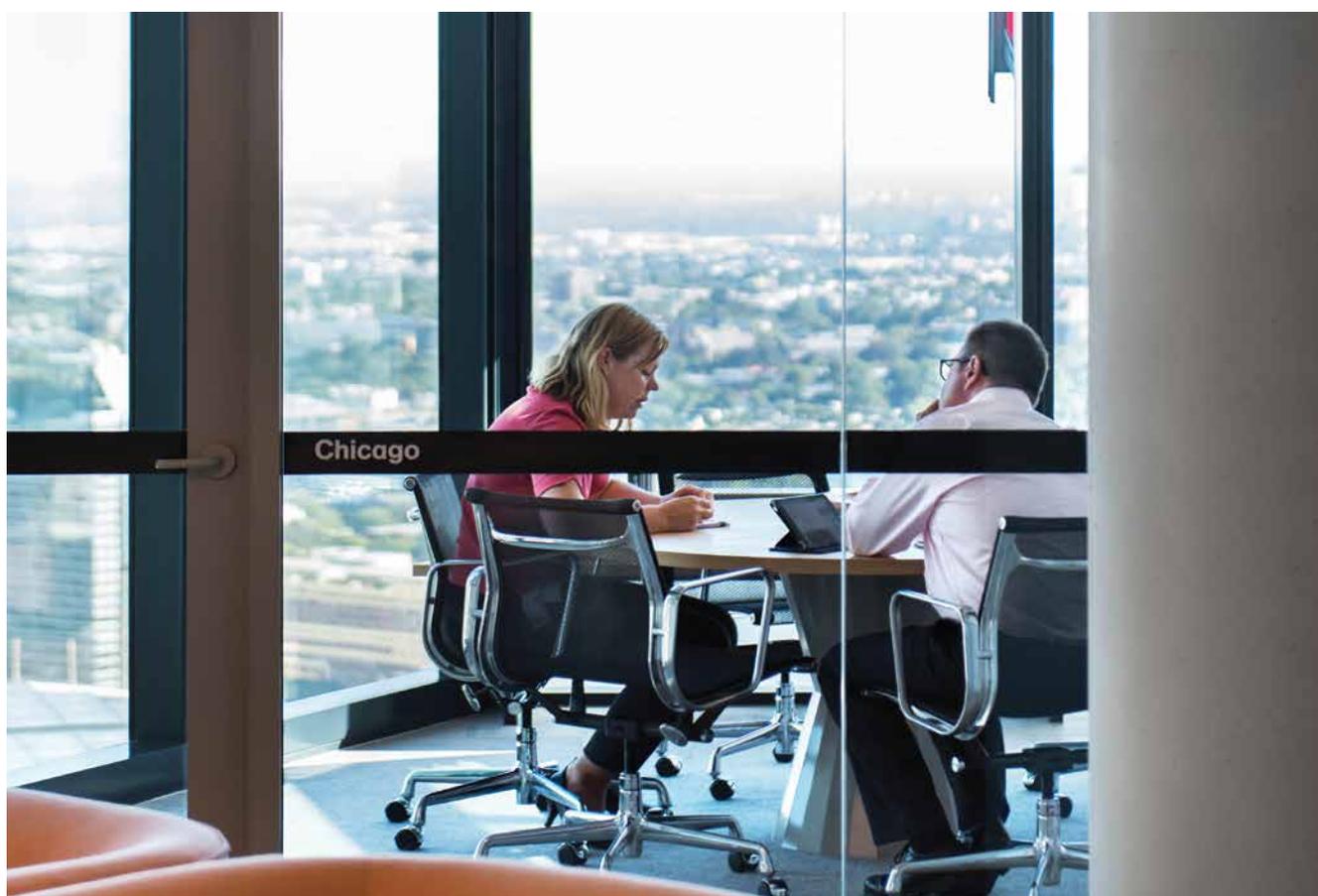
Additionally, the Corporations Act provides for a DOCA to be set aside on an application to the Court (in particular circumstances), and for a DOCA to be varied including by resolution of creditors.

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

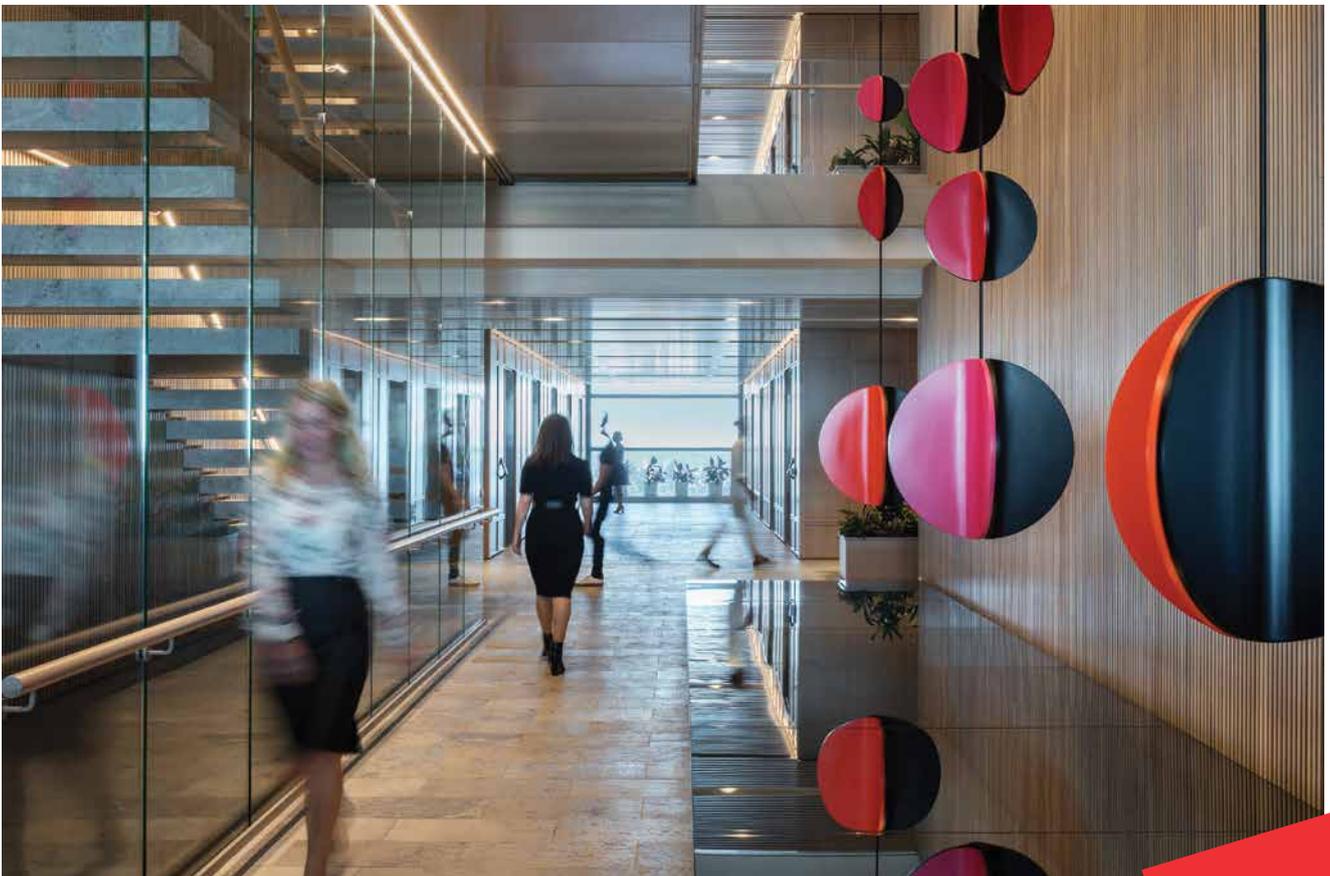
formal insolvency regime, the company essentially avoids any period of external control by an insolvency practitioner. As a restructured solvent outcome has been prearranged, stakeholders are able to be proactively managed and the perceived impact of the process is less damaging than with other forms 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.

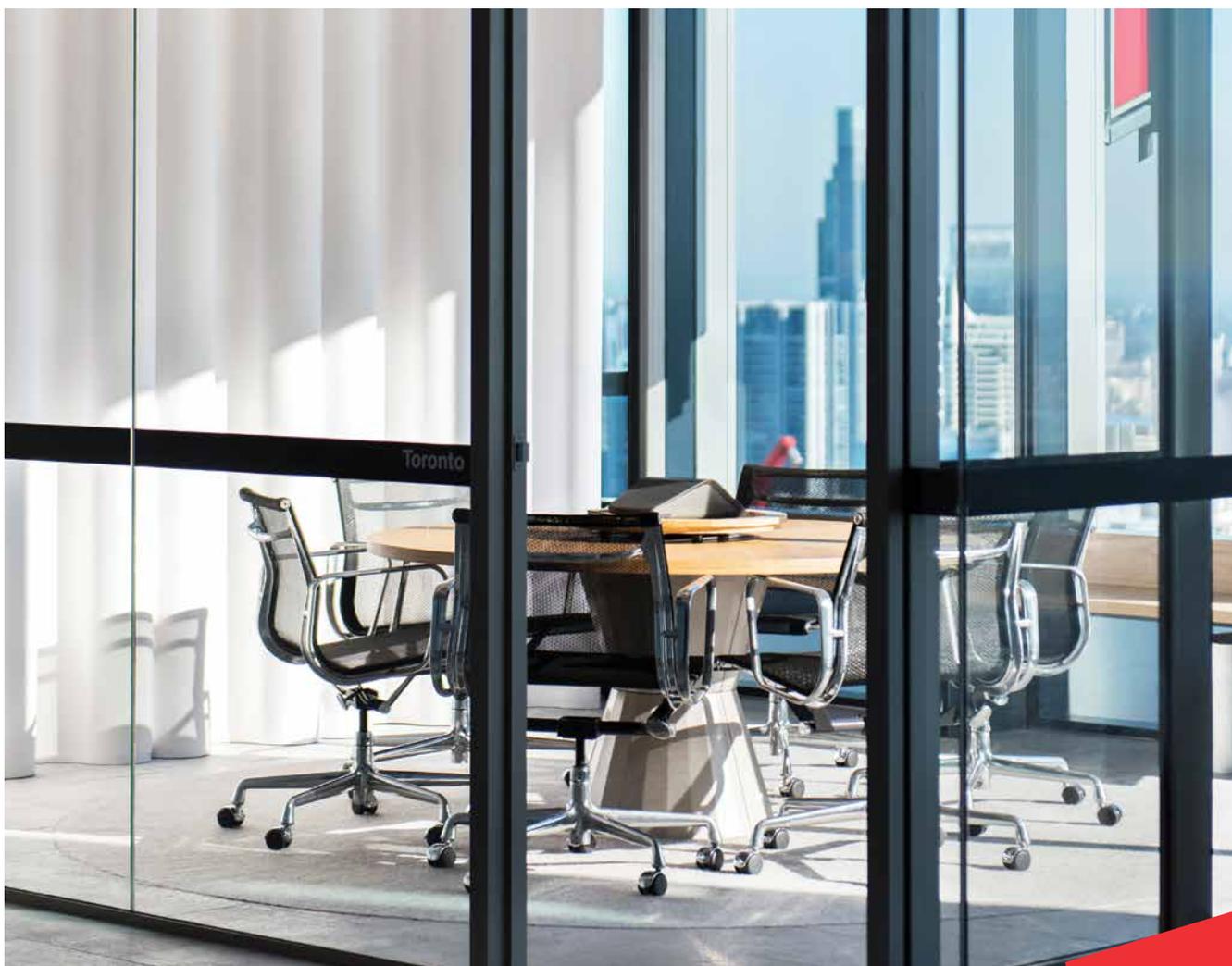
Impact of a receivership

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 a receiver can appeal to the Court.

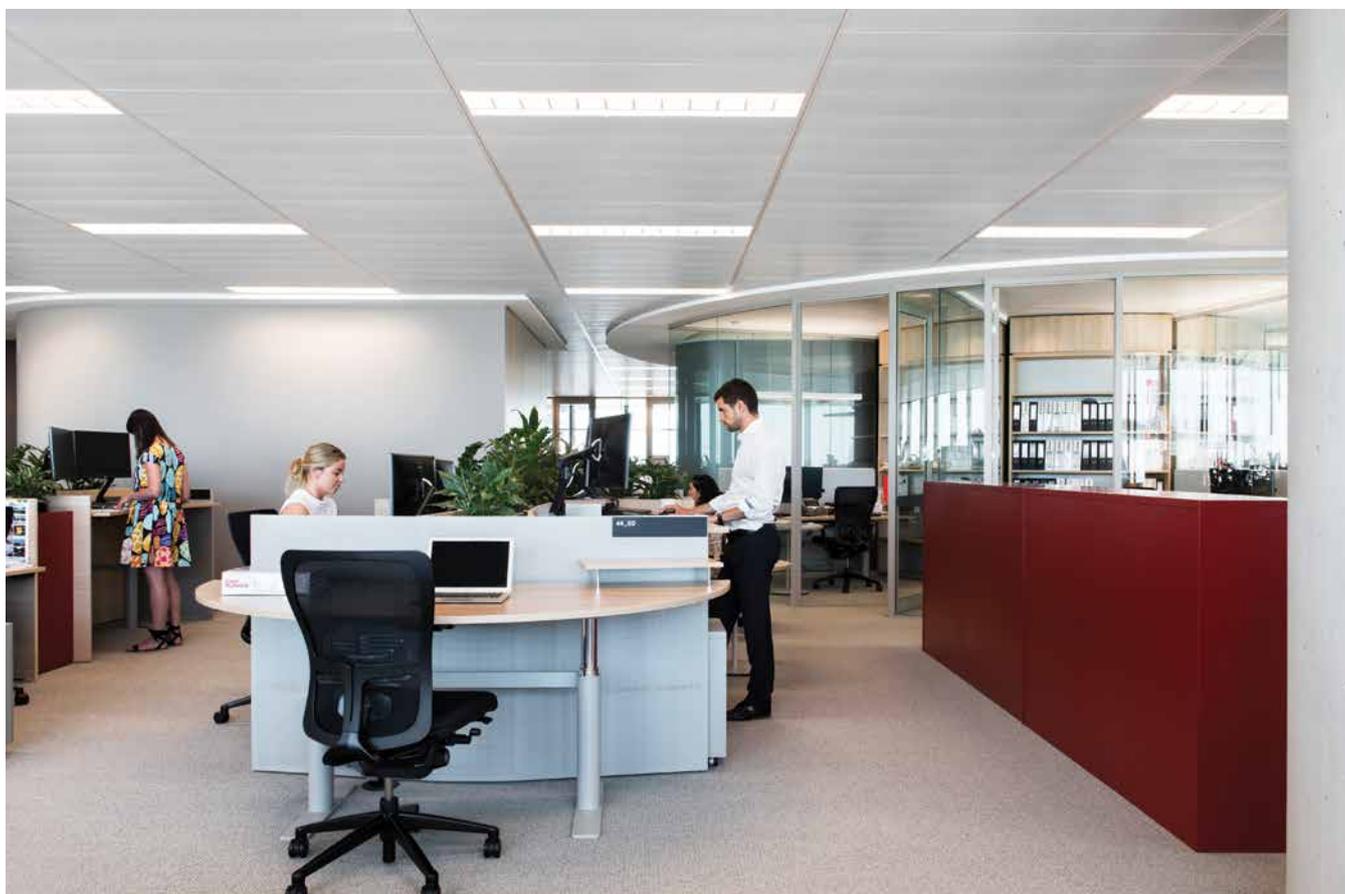
Concurrent voluntary administration/winding up and receivership

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.

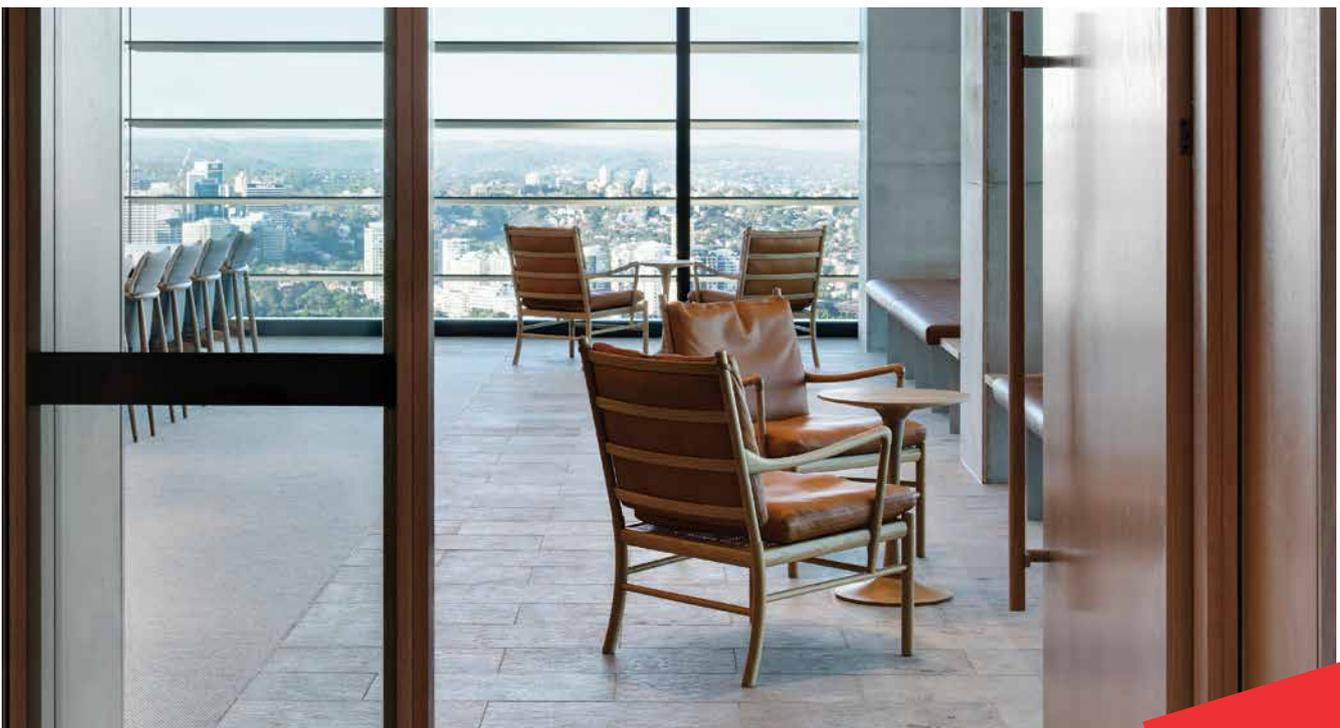
Whether a transaction is "uncommercial" is assessed by reference to, among other factors, the benefits and detriment to the company and to other parties of entering into the transaction. The test for what constitutes an uncommercial transaction has been expressed as "a bargain of such magnitude that 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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