

Morning Briefings

INTRODUCTION TO

# Insolvency

A broad overview of the area of insolvency

18 February 2015

**Disclaimer**

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## ***Technical definition of insolvency***

The statutory definition of ‘solvent’ is contained in Section 95A of the Corporations Act 2001, which provides:

*“95A(1) A person is solvent if, and only if, the person is able to pay all the person’s debts, as and when they become due and payable.*

*95A(2) A person who is not solvent is insolvent.”*



An inability to pay debts as and when they fall due constitutes the general law concept of insolvency.



Importantly:

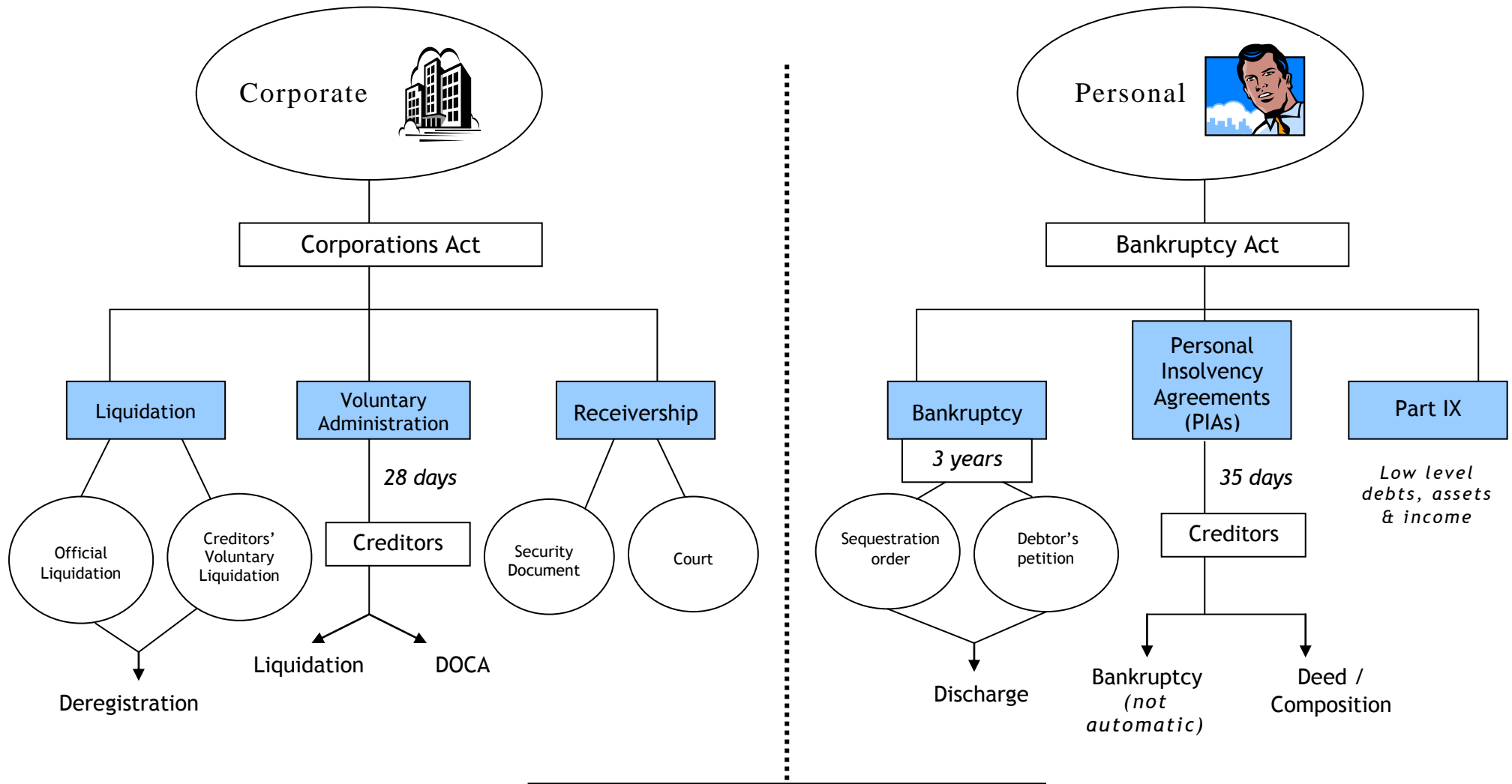
- (i) Insolvency is determined by a commercial or cashflow test rather than on a balance sheet approach. The court looks at the company’s position in its entirety and asks whether the company’s assets are in such a position as to title or otherwise that they can be realised in time to pay its debts as they fall due.
- (ii) Furthermore, it has been held that if the assets in question form an essential part of the company’s business, such that it will be unable to continue to trade if they are sold, the court will not consider them assets available for the payment of creditors.

The important question is:

***“Can the company pay its way in carrying on its business?”***



## Principal Insolvency Options



- ★ *Provisional Liquidation*
- ★ *Mortgagees in Possession*
- ★ *Schemes of Arrangement*

1. **Asset realisations**
2. **Distribution to creditors**
3. **Investigation**

## *Outcome for directors in liquidation*



- Lose control of their business and company (the end of their business / project).



- Generally directors are not liable for company debts (the corporate veil).
- However, there are 4 main exceptions:
  1. **Directors' guarantees** to financiers and trade creditors - which may be secured against directors' personal property (e.g. family home).



### 2. Director penalty notices (DPNs)

- 1993 - ATO lost its priority and DPNs were introduced.
- Originally DPNs were served on directors for unremitted PAYG.
- In 2012, the DPN provisions underwent major legislative revision.
- Now DPN laws mean that a director may be held personally liable for unpaid PAYG and superannuation contributions.

## ***Outcome for directors in liquidation (cont.)***

### **3. Claims from a liquidator**

Claims generally fall into 2 main areas:

- insolvent trading.
- breach of fiduciary duties.

### **4. Statutory indemnity to the ATO for voidable transactions**

If the ATO is ordered to repay to the liquidator a previous payment to the ATO by the company which has been found to be a 'voidable transaction', the ATO is entitled to make a claim against the directors for the amount disgorged by the ATO.

## *Outcome for bankrupts*



- The principal penalties for bankrupts are:
  - loss of assets (subject to exemptions) at the date of bankruptcy.
  - possible income contributions during bankruptcy.
  - loss of any assets acquired during bankruptcy: inheritances / windfalls (lottery wins).
- Bankruptcy lasts 3 years (but can be extended to 5 or 8 years, or even run indefinitely). Cannot be shorter except in the event of annulment or a composition with creditors.



- During bankruptcy, a bankrupt:
  - may not manage a corporation.
  - must maintain contact with trustee.
  - must assist trustee with any queries (including investigation queries).
  - must disclose income earned during bankruptcy.
  - may not travel abroad without permission of the trustee.
  - must disclose bankruptcy if applying for credit greater than \$5,398.\*
- Permanent record of bankruptcy on AFSA's NPIL.



\* Current at 18 February 2015

## ***Outcome for bankrupts (cont.)***

- Asset exemptions (non-divisible assets):
  - superannuation (as long as contributions are not made in order to defeat creditors).
  - vehicle used for transport - \$7,500.\*
  - tools of trade to earn income - \$3,650.\*
  - necessary household property (antique items are not classified as household property).
  - rights and recoveries of the bankrupt in relation to compensation for death or personal injury or wrong.
  - sporting, cultural, military or academic awards made to the bankrupt in recognition of their performance.
  
- Proceeds of Crime Act restraining orders or forfeiture orders generally have priority.

\* Current at 18 February 2015

## ***Rights of directors/debtors and creditors***

### 1. Directors/debtors

If they act soon enough, they may have the chance to effect an option other than liquidation or bankruptcy.

### 2. Creditors

With the outlay of further funds, they can force a liquidation or bankruptcy.



## *Conclusion*

The earlier financial problems are addressed:

- (i) The earlier:
  - appropriate professional advice can be obtained.
  - corrective action can be taken.
- (ii) The greater the chance that the client can effect a formal arrangement with creditors, to assist in making a fresh start by compromising their debts and obtaining a release from liabilities which might otherwise cripple the business or the individual.
- (iii) The less likely that the directors may become personally liable for company debts.

