

# A Practical guide to corporate insolvency



**A COURTESY GUIDE PREPARED BY SWAAB**  
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## INSOLVENCY

Under section 95A of the *Corporations Act 2001* (Cth), an insolvent company is one which is unable to pay all the company's debts as and when they become due and payable.

## INDICATORS OF INSOLVENCY

There are various indicators which can be used to determine whether a company is insolvent. These include:

- a. Continuing losses  
A loss or losses do not on their own make a company insolvent. Insolvency generally results from a combination of losses and insufficient working capital.
- b. Liquidity ratio below 1  
A liquidity ratio is the result of dividing the total liquid assets by the amount of short-term borrowings, which shows whether the short term liabilities are covered. If the result is greater than 1, it means the liabilities are fully covered.
- c. Overdue Commonwealth and State taxes
- d. Poor relationship with bank including inability to borrow further funds
- e. No access to alternative finance
- f. Inability to raise further equity capital
- g. Suppliers placing the debtor on COD terms or demanding special payments before resuming supply
- h. Creditors unpaid outside trading terms
- i. Issuing of post-dated cheques
- j. Dishonoured cheques
- k. Special arrangements with selected creditors
- l. Solicitors' letters, summons, judgments or warrants issued against the company
- m. Payments to creditors of rounded sums, which are not reconcilable to specific invoices
- n. Inability to produce timely and accurate financial information to display the company's trading performance and financial position and make reliable forecasts

## TYPES OF INSOLVENCY ACTION

### LIQUIDATION

Liquidation generally occurs because members want to wind up the company to cease its existence or because the company has become insolvent and there is no avenue available for saving the company. Liquidation is undertaken by a liquidator who investigates the position and assets of the company and provides for a dismantlement of the company and distribution of its assets in a fair and orderly fashion.

Liquidation due to insolvency can occur as:

#### a. Creditors voluntary liquidation

After a determination by the directors that the company is insolvent, both the directors and the members can resolve that the company be placed into liquidation and a liquidator is appointed. A meeting of the creditors is later held where the creditors have the opportunity of changing the liquidator.

#### b. Court liquidation

In these circumstances, there is no agreement that the company is insolvent. A person (usually a creditor) can make an application to court to have the company wound up.

### VOLUNTARY ADMINISTRATION

Under a voluntary administration, the directors decide whether the company should appoint an administrator. A resolution of the members is not required. The creditors are later given an opportunity to appoint an alternative administrator at a creditors' meeting. After an investigation into the affairs of the company, the administrator produces a detailed report which outlines his/ her findings. The administrator also sets out the options available to the company. These options comprise the company entering into a deed of company arrangement (DOCA), placing the company into liquidation, or ending administration and handing back control of the company to the directors.

## RECEIVERSHIP

A receiver is a type of administrator who is generally appointed under a power contained in an agreement between a company and a secured creditor. The receiver is appointed to raise enough money in the company to pay the secured debt under which agreement the receiver was appointed.

A receiver can also be appointed by a court to protect the assets of a company or to carry out other specific tasks.

## DEREGISTRATION

Even after a company has ceased trading or has become insolvent it remains registered on the ASIC register. Once a company has been wound up and liquidated, it can be deregistered, at which point it will cease to exist. To be deregistered, a company must meet several requirements, including not having any liabilities, not being a party to any legal proceedings and not having assets of a value greater than \$1,000.

## SPECIFIC INSOLVENCY ISSUES

### PREFERENCES

Certain payments made by an insolvent company to creditors before a liquidator is appointed may be considered to have given those creditors preferential treatment over the other creditors of the insolvent company. During a particular timeframe, and under particular circumstances, a liquidator can seek an order from the court to claw back the money from the creditor who was paid in preference to the other creditors.

### INSOLVENT TRADING

Directors of a company carry out insolvent trading if, while they were directors of the company:

- a. the company continued to trade while insolvent; or
- b. the company became insolvent by incurring a debt, while there were reasonable grounds for suspecting the company was, or would become, insolvent.

Insolvent trading can result in penalties up to \$200,000.

Compensation proceedings can be instituted against directors personally in addition to the civil penalties. These actions can result in personal bankruptcy which disqualifies the bankrupt director from being a director of, or managing, a company.

If dishonesty is a factor in the insolvent trading, a director could be subject to criminal charges. The penalty for these charges can amount to \$220,000, or five years in prison, or both.

### UNCOMMERCIAL TRANSACTIONS

An uncommercial transaction is a transaction which a company has entered into which can be considered as being unreasonable considering the financial position of the company at the time. A liquidator may be able to set aside an uncommercial transaction if it occurred under particular circumstances and within a particular period of time before his/ her appointment.

### EMPLOYEE ENTITLEMENTS

Employees have the right, after payment of the liquidator's fees, and any secured creditors, to payment of their outstanding entitlements in priority to other unsecured creditors. Outstanding employee entitlements are prioritised in the following order:

- a. Wages and superannuation
- b. Leave
- c. Retrenchment.

It is an offence to enter into a transaction or agreement which has the intention of avoiding the entitlements of a company employee. Current or recent directors and employees who are relatives or spouses of current or recent directors do not have the same range of entitlements as all other employees.

### DIRECTORS LIABILITIES

Directors may be liable for the debts of the company even if they have attempted to solve the financial problems of the company. Personal liability may arise in relation to the following areas:

- > Personal guarantees;
- > Employee Entitlements;
- > Superannuation contributions;
- > Tax debts; and
- > Compensation for insolvent trading.

### PENALTY NOTICES

There is a legal responsibility on directors of companies in Australia to ensure their company pays its PAYG withholding and superannuation guarantee charge obligations. Directors of companies that fail to meet the above liabilities become personally liable for a penalty in the same amount as the outstanding liability of the company. New directors have 30 days before they become liable for the outstanding liabilities.

Where a company fails to meet these liabilities, a penalty notice may be issued. A penalty notice can be the first step towards legal proceedings, but even without it the ATO can collect the penalty in other ways (e.g. withholding a tax refund). There are certain statutory defences to the penalties.

### LANDLORD RIGHTS

Voluntary administrators and receivers of companies are liable for rent for the premises leased by the company if the company continues to occupy the premises seven days after the appointment. This seven day period gives the insolvency practitioner an opportunity to make the decision whether or not the company will vacate the premises.

The insolvency practitioner is not liable for the breach of the lease which has occurred due to the tenant not paying rent. A landlord cannot demand immediate removal of the tenant in these circumstances, but can still rely on the terms of the lease to evict a tenant if necessary, which means following the normal eviction process. However a company under administration is protected from being evicted from the property unless the landlord has the consent of the administrator or leave of the court.

## LEGAL ADVICE

There are serious consequences that may flow from not properly dealing with a company which is grappling with insolvency issues.

Committing to the right advice early can help to smooth the path when dealing with company creditors, and can limit the exposure of directors to civil or criminal actions and possibly even help to avoid liquidation completely.

## CONTACT US

The corporate team at Swaab is committed to working with companies to help them meet their ambitions. If we can help you with any of the issues raised in this Guide, please contact Angela Harvey. We would be very pleased to discuss any issues with you



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For more information or for copies of other Swaab publications please visit our website [www.swaab.com.au](http://www.swaab.com.au)

This Guide is only intended to give an overview of the issues involved. It is not intended to be fully comprehensive or to be a substitute for legal advice.

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