



White Paper
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Managing Corporate Insolvency

Abstract

Company managers need to expect the risk of insolvency when they do business. Economic circumstances and events can dramatically alter the commercial environment, sometimes at short notice.

While business risks are usually managed during the company's operation in the marketplace, managers tend to overlook the risk of insolvency. Fortunately, the voluntary administration scheme can assist a company to regain profitability and trade out of difficulties. Often, the company is wound up.

Legal and accounting advisers need to provide sound advice to company managers for effective corporate governance of the company and its relationships with its employees, creditors, regulatory authorities and external influences that impact the company and its operations. This involves making sure the company has policies, practices and procedures in place that comply with the Corporations Act and the law generally.

This paper provides a legal and commercial guide to managing companies facing insolvency.

Introduction

Managing risk, like complying with the law, is vital to the company's performance and its profitability. To be profitable, a company needs to comply with the requirements of the *Corporations Act 2001* and other laws regulating its trading and operational activities. Not knowing the law or operating a business without accurate knowledge of the law is a significant risk factor.

While there are a range of laws with which companies must comply, companies are exposed to market forces and market structures that present other risks for them. These risks can impact on the operations of a company bringing adverse consequences for the viability of the company. The company may appear to be operating profitably but its debts may be increasing, placing a strain on its solvency.

Market forces affect risk management and profitability

The report of the review of the competition provisions of the *Trade Practices Act 1974* (*Review of the Competition Provisions of the Trade Practices Act January 2003*) shows that structural reform of the Australian economy and changes to regulatory frameworks has seen improved competitive business activity. The report notes:

“Whilst the changing environment of Australian business has provided substantial opportunities for investment, it has also presented some challenges. Corporations must respond to developments in market conditions that may occur quickly and may be influenced by international, as well as domestic, competition. For some businesses, including those in industries that have experienced significant structural change, the new environment involves dealing in less regulated markets or with large businesses that have greater market power.”

The discipline of freer market conditions is the toning of companies to respond to changing circumstances and to compete effectively against companies in the same market. The report of the Trade Practices Act competition provisions expresses the situation:

“In a competitive market, each participant seeks to constrain costs to maintain its position in the market and achieve some advantage over its competitors. Business decisions made in response to competitively determined prices direct resources within the economy to where the best opportunities lie.”

The response of company managers needs to recognise the changing circumstances and to position the company to be first in the market with new products that are demanded by customers. The focus needs to be on the company's competitive performance in the market to maximise its members' value. However, corporate governance measures need to be in

place to ensure the company complies with the law and in particular, the Corporations Act which is the source of existence for the company.

The changing nature of the Australian economy and the response by company managers is expressed in a Business Council of Australia future directions publication, *aspire australia: contributions to the future directions project* (2002):

“Australia has been involved in a process of major and sustained reform since the 1980s. It has helped restructure the Australian economy and its business and government practices in ways that have paid off handsomely. The country’s growth in output and productivity has been at the highest levels of performance among industrial countries.

There are important areas for which reform is still needed and should be pursued. But given the reform fatigue and given the fact that reform to date has largely been that of removing impediments to growth, there is a need for a new stage of policy development. This is appropriately being identified in the community as “nation-building”.

This can be interpreted as capturing the need for Australia to enhance its capability to respond to the challenges of economy, society and environment through renewed investment in the skills, knowledge and resources required for the new century. We have moved well towards being an open and flexible economy, having freed ourselves from many past impediments. There are more domestic and international impediments to confront, but sustained growth also requires better attention to equipping the nation to compete.”

The future for change envisages greater competitive factors affecting Australian companies. The remaining protective measures contributing to impediments to freer market activity will be dealt with to provide a more competitive business environment for companies. Company managers need to be more equipped and resourced with knowledge and experience to manage their companies more effectively. The right directors and senior executives will advance company performance to increase shareholder value.

The response of reform fatigue is not an appropriate one for the advancement of a competitive company in the Australian economy. Company managers need to improve their performance and have plans in place for the strategic performance of their companies into the future. This may require making corrections and structuring the company to achieve stated goals to take advantages in the marketplace to capture more market, intensify product penetration and to diversify production to meet changing competitive demands.

Company managers need to oversee and supervise its operations

The need for company officers to oversee and supervise the company's operations is an obvious and basic tenet of management. However, it is a major failing that even the large Australian corporations are subjected. The recent *Investigation into foreign exchange losses at the National Australia Bank* (12 March 2004) by PriceWaterhouseCoopers identified critical weaknesses in the integrity of the people, risk and control framework, governance and culture. There are lessons that can be applied to all Australian companies.

Weakness in the integrity of the people

The staff involved in foreign exchange trading used a "smoothing" practice which effectively misstated profit and loss information about currency options. False transactions were processed to conceal the true financial position of the currency options desk which was incurring significant losses. The report of the investigation notes about the integrity of the people:

"They did not behave in an honest manner and concealed losses on the assumption that one day, they would earn enough profit to reverse the previously concealed losses."

According to one trader the practice of smoothing was unrealistic. It appears that the practice was a stated goal of the Bank to achieve incremental improvements of around ten percent. In practice, this goal translated in one trader's case as \$3.5 million at daily risk for an annual profit of \$35 million (Cornell A, "Banking's time-bomb", *Australian Financial Review* 15 March 2004 at 55).

The weaknesses in the integrity of the people did not stop with the traders. The board and senior management did not invest in systems to maintain control over the management of the Bank. The board did not maintain ultimate responsibility for the management of the Bank (*Dairy Containers Ltd v NZI Bank Ltd* (1995) AGLC 3211).

Weakness in the risk and control framework

Business units have the responsibility to manage risk and financial control within the National Australia Bank. Other levels of supervision within the Bank (Group Risk and Group Finance) analyse, monitor and report on the procedures of the business units. The report notes that this approach "is consistent with the approach taken by many large financial institutions."

The business units are allowed relevant discretion in the management of their operations. A matrix of responsibility between business units, managing risk, operational and financial areas is used as an enterprise-wide approach. Each area reports separately to the chief executive

officer. This business model provides business units the ability to make decisions as they see fit in the circumstances of their particular operations.

The weakness of this business model is the inconsistent approach to managing risk and financial control across all business units. The report observes that “there is no one model of risk management and financial control which is best practice.” The hope of consistency in approach across business units is left to standards and benchmarks set by outside organisations that have regulatory responsibility or standards setting functions.

Supervision of traders was minimal on a daily basis. Incorrect signals were observed by other areas of the Bank and interpreted as the result of the correct application of strategy for the making of profits. External warning signs from the market were ignored or not investigated properly and the trading behaviour of traders were not checked despite occasional observations of excessive risk-taking by them. Processes for the calculation of daily risk positions were not consistent, producing differences of opinion about breaches of limits of trade for the day. The consequences are observed in the report:

“If limit breaches were not being investigated properly and [Value at Risk] could not be calculated reliably, then effective risk management of currency options was not possible and good business sense would require trading to be carefully managed, curtailed or ceased altogether.”

Large numbers of transactions or unusual transactions were also entered into by traders. In some cases these involved another bank that raised concerns to the National Australian Bank. To protect their situations, the traders gave an explanation as observed by the report:

“The explanation given was that the deals were done to help fund their cash position and the transaction was cheaper than borrowing the funds internally through the National’s funds transfer pricing system.”

Complaints by other banks about the size of transactions and risk profiles were met with the response as reported by the investigation:

“Effectively, the message conveyed to the other bank was that if rumours of this nature emanated from them (or the brokers used by the other bank), the National would end its dealing relationships with the bank/broker concerned.”

The consequence of these practices was that they remained unchecked. The report notes that an independent investigation of the practices within the National Australia Bank did not occur. Also, the concerns expressed by other banks were internalised and not reported to the chief executive officer or the board of directors.

Weaknesses in the management of risk

The report of the investigation notes:

“It is clear that there were flaws in the design, implementation and execution of risk management....The situation was exacerbated by a lack of clarity in relation to the division of risk management responsibilities...Accordingly, while risk was an acknowledged business concern, there was a tendency to ‘push the boundary’ on risk in pursuit of revenue targets.”

The lack of clarity of the division of risk management processes and procedures meant that proper procedures were not in place to guide practices to check on possible improper trading activities. The focus on revenue targets appears to support the saying that the ends justify the means irrespective of the consequences. This view appears to have prevailed given the long period (at least three years) in which the trading behaviour continued.

While daily risk reports noted a large number of limit breaches in accordance with agreed procedures, the reports did not escalate concerns about the continuation of these breaches. Despite other approval procedures to escalate breaches of established processes within the Bank, unapproved transactions continued to be entered into by traders with “relative impunity” according to the report of the investigation.

Parameters for the valuation of currency options were not reviewed to examine their reasonableness in the context of the prevailing market conditions.

Weaknesses in the control of financial transactions

Transactions could have been monitored by financial controls within the Bank. Investigations of transactions from a financial control perspective did not occur. Nor did analyses of profit and loss deal volumes, drivers, market price movements against the size of portfolios and their relative risks. The investigation report notes:

“It is not clear who had responsibility for the above controls, but it is apparent that controls either did not exist or did not operate effectively.”

Weaknesses in back office procedures

The back office processes all transactions involving verification, confirmation, settlement, reconciliations and end-of-day processing. Gaps in the back office procedures allowed traders in the Bank to enter into false transactions. For example, validation processes carried out by the back office were based on information produced about an hour after determining the daily profit and loss. False transactions entered into during the gap were reflected in the results reported and later amended or surrendered to not include them in the information used by the back office for validation purposes. The amended or surrendered transactions were not checked for their validity as the transactions were assumed to be matched automatically.

Weaknesses in governance and culture

“The Board is ultimately responsible for any financial loss or other reduction in shareholder value suffered by the organisation. It has a duty to shareholders to ensure that the requisite systems, practices and culture are in place to manage all the risks to which the organisation is exposed.”

This statement from the report of the investigation summarises the responsibility of the board of directors. The report identifies that the board should have been informed about the foreign currency situation and notes:

“A number of reports which could have identified matters relevant to the foreign currency losses were submitted to the Board, committees of the Board, and management groups.”

While a number of issues are raised in the report about the number and types of reports made showing the foreign exchange trading situation, changes to processes such as auditing structures and responses to the regulatory authority, gave the impression that the matters raised were minor and being dealt with by the Bank.

In relation to internal culture, the report states:

“In most trading environments a healthy tension exists between the dealers and those engaged in risk management processes. The Traders were seen by many in the National, including junior traders on the desk, as having an aggressive and arrogant attitude.”

This culture affected staff performance in other areas. The difficulties in dealing with traders contributed to staff changing roles within the Bank to avoid the on-going tension.

The findings of the investigation as detailed in the report show that:

- the focus was on process, documentation and procedures manuals rather than on understanding the substance of issues and the taking of responsibility to resolve matters
- responsibility is passed on rather than assumed by management
- significant issues were not escalated to the board of directors
- a focus on suppressing any bad news rather than engaging in a rigorous account of events and circumstances

- assumptions were made by the board and its committees about the accuracy of information presented to them by staff
- the lack of supervision of traders meant that they operated unchecked and they flouted the rules and standards set by the Bank.

These issues present timely warnings not only to other banks and financial institutions but to all company managers. While this analysis of the investigation into the foreign exchange trades by staff of the National Australian Bank does not in any way raise issues of insolvency, it does identify what can go wrong in the management of a company that could lead a less resourced company into insolvency.

Application of findings to the management of companies generally

The findings in the report of the investigation into the foreign exchange dealings of the National Australia Bank have application to the management of companies. The more obvious issue is the need to have proper structures, processes and procedures for good corporate governance purposes. This is essential for all companies including those that may become insolvent. At all times, company managers must not only oversee the operations of the company but to supervise the operations and those undertaking activities for the company. While management may delegate responsibilities it cannot delegate control.

Proper accountability processes need to be in place to promote a sound culture within the company and assurances that staff are performing their tasks according to the requirements of the company and as imparted to them through training and other information sharing processes. The business model used by the company needs to be understood by employees and consistently applied throughout the company's operations and activities.

All financial transactions made on behalf of the company need to be transparent to management. All delegated authority to enter into commercial arrangements with third parties or with directors and others in the company and related parties in the giving of guarantees, for example, need to be clearly documented. Revenue targets need to reflect the realities of prevailing economic conditions and the competitive market circumstances. They must not only focus on incenting employees to perform better to increase the company's profitability within a set time-frame. Company managers need to know what is happening in the company at all times and not rely on periodic advice from time to time. This knowledge needs to be obtained diligently from internal information obtained from staff or from further investigation and from external signals as perceived from the exercise of the relevant knowledge and skills and experience of directors.

Responsibility for company management

Company managers and in particular directors need to be responsible and understand their responsibilities. This includes managing the company and its operations for profitability or when the company is likely to become insolvent.

Generally, directors are responsible for the good working relations within the company to ensure processes and structures are in place for employees to carry on the business of the company as directed by the board of directors. The report of the investigation into the foreign exchange dealings within the National Australia Bank states the situation as:

“ultimately the Board and CEO are responsible for the culture in the organisation. The Board and CEO must accept responsibility for the ‘tone at the top’, and for the environment in which management did not report openly on issues in the business.”

The ultimate responsibility for managing the company resides in the (Corporations Act 2001, s 198A(1)). Directors must take this responsibility seriously and not acquiesce in their performance of this responsibility (*Metal Manufactures Limited v Lewis* (1986) 11 ACLR 122, *Metal Manufacturers Limited v Lewis* (1988) 13 NSWLR 315).

The Corporations Act requires a company’s directors “to address their minds to the affairs of the company.” (*Metal Manufacturers Limited v Lewis* (1988) 13 NSWLR 315 per Kirby P at 319) Directors are now required to give “higher levels of attention to the affairs of a corporation and its dealings with the outside world than was the case in the past.” (*Metal Manufacturers Limited v Lewis* (1988) 13 NSWLR 315 per Kirby P at 319)

The responsibility of the board of directors in particular and that of other company officers is stated in *Dairy Containers Ltd v NZI Bank Ltd* (1995) ACLC 3211 at 3222:

“It is because of the separation of ownership from management in corporate theory and practice that directors are appointed to manage the company in the absence of the owners. The directors may delegate powers and functions using the term in a broad sense but they cannot delegate the management function itself. Executives in running the day-to-day business of the company are exercising delegated powers. It is to be borne in mind always that they are delegated and not original powers, and that they are therefore subject to the ultimate responsibility of the directors for the oversight of the company.”

The composition of the board of directors usually includes non-executive directors who are independent directors. By having a majority of these directors on the board should provide the company with assurances that management is conducted in a proper manner in accordance with the law. Corporate governance codes tend to support this notion of independence at the

board level. However, the effectiveness of independent directors is questionable. The HIH Royal Commission (*The failure of HIH Insurance Vol I* at 112) notes:

“The board of HIH had several ‘independent’ directors but this provided little protection against the folly of management.”

The role of the board of directors and its relationship with company managers is vital for the effective management of the company. This relationship needs to be transparent and trust needs to be strong based on the confidence of directors and senior managers to perform their functions in order to promote shareholder value. The particular nature of the relationship is described in the report of the HIH Royal Commission (*The failure of HIH Insurance Vol I* at 118-119):

“The effectiveness of interaction between the board, in particular the non-executive directors, and management is central to good governance. The chair’s own relationship with the chief executive should set the tone for this. In a healthy company relations will be straightforward and open, with the board supportive of management’s efforts where it can. But this all presupposes trust and confidence in the information and advice that is provided and in management’s responsiveness to requests for information or explanation. Where trust breaks down, change is likely to be called for.

Directors have a responsibility to request more information where necessary to fulfil their duties. They cannot simply rely upon the information presented by management.

Moreover, by taking an active responsibility for the agenda, the chair can ensure that management brings forward on a regular or periodic basis reports or other information on material aspects of the company’s business and performance.”

Company officers are required by the Corporations Act to perform their duties “with a degree of care and diligence that a reasonable person would exercise” (*Corporations Act 2001*, s 180(1)). The business judgment rule set out in section 180(2) of the Corporations Act assists company officers meet the reasonable person test provided the criteria listed in the section are met. The criteria for making a business judgment (or the taking of action or not taking action in relation to the company’s operations) are that it:

- is made in good faith and for a proper purpose
- contains no material personal interest
- is based on the reasonable belief in the information about the subject-matter is appropriate
- is made in the rational belief that it is in the best interests of the company.

Business judgments need to take account of the interests of shareholders. However, where the company has creditors, business judgments may need to take account of the interests of creditors where shareholders and directors are likely to be displaced by the company's creditors by the appointment of an external manager to the company (*Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722). In this situation, the creditors may have a beneficial interest in the company's assets or have a contingent interest (*Nicholson v Permakraft (NZ) Ltd (in liq)* [1985] 1 NZLR 242; (1985) 3 ACLC 453).

While the business judgment rule operates to protect business decisions it only applies to the duty of care and diligence of directors in the exercise of powers and functions of the company. That is, decision made during the usual operations of the company. It does not apply to the director's duty to prevent insolvency (Horsington H, *Directors' Duties During Insolvency*, Lawbook Co 2001 at 198).

The responsibility of each director and the board of directors as a collective management group is expressed in *Daniels v Anderson* (1995) 37 NSWLR 438 at 505:

"A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office. None of this is novel. It turns upon the natural expectations and reliance placed by shareholders on the experience and skill of a particular director. The duty is a common law duty to take reasonable care owed severally by persons who are fiduciary agents bound not to exercise the powers conferred upon them for private purposes or for any purpose foreign to the power and placed, in the words of Ford and Austin Ford's *Principles of Corporations Law*, 6th ed (1992), at 429, at the apex of the structure of direction and management. The duty includes that of acting collectively to manage the company."

A director who does not perform at this standard of care is negligent in their duty to the company. The prevailing law in relation to directors' responsibilities for the management of the company was stated by Spigelman CJ in *Deputy Commissioner of Taxation v Clark* [2003] NSWCA 91 (with whom Handley JA and Hodgson JA agreed):

"For present purposes it is sufficient to note that there will be circumstances in which a director will be found not to have been negligent, by failing to make inquiries or otherwise participate in the decision-making processes of the company, when that director acts in reliance on assurances from, or the conduct of, another director whom he or she has come to trust. That this is so does, in my opinion, illuminate the scope of what is capable of constituting "good reason" for purposes of

the various statutory provisions in which the formulation appears. However, nothing in *Mallina Holdings* suggests that total non-participation is permissible.

What constitutes breach of the standards of care and of diligence, in a particular case, will depend on a wide variety of circumstances including the precise nature of the business conducted by the company and the composition of its board. However, the case law indicates that there is a core, irreducible requirement of involvement in the management of the company.

Although the standard of skill may vary in accordance with the particular skills of the director, the core, irreducible requirement of skill involves an objective test, such as “ordinary competence” (*3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371 at 373 per Foster J) or “reasonable ability” (*Rema Industries and Services Pty Ltd v Coad* (1992) 7 ACSR 251 at 259 per Lockhart J). An equivalent objective test applies to the core, irreducible requirement of diligence, such as “reasonable steps to place themselves in a position to guide and monitor the management of the company” per Rogers CJ CommD in *AWA Limited v Daniels* (1992) 7 ACSR 759 at 864, adopted by Clarke and Sheller JA on appeal in *Daniels v Anderson* (1995) 37 NSWLR 438 at 501.

The existence of a core, irreducible requirement of participation in management was one of the factors underlying the scheme for insolvent trading which falls to be construed in the present case.” (Some citations expanded)

Duty to prevent insolvent trading

The company’s directors have a duty to prevent insolvent trading (*Corporations Act 2001*, s 588G, 588H). They need to ensure that at the time when a debt is incurred they had reasonable grounds to expect, and they did expect, that the company was solvent at that time. Also, the directors’ expectations include that the company would remain solvent even if it incurred that debt and any other debts that it incurred at that time (*Corporations Act 2001*, s 588H(2)).

However, when the company becomes insolvent or it is likely to do so at some time in the future the burden on directors is intensified. The regime for regulating circumstances of insolvent trading under the *Corporations Act* deliberately seeks “to impose a heavier burden on directors and other officers of companies which happen to become insolvent.” (*Statewide Tobacco Services v Morley* [1993] 1 VR 423 at 430) The basis for this was observed by Ormiston J in *Statewide Tobacco Services v Morley* that this “is part of a consistent legislative pattern over recent years, whereby the duties and obligations of directors and company officers have been increased and made more onerous.”

The Australian Law Reform Commission Report No 45, *General Insolvency Inquiry*, Canberra, 1988 (**Harmer Report**) earlier noted that directors “should be responsible for ensuring that the solvency of their company be monitored on a continuing basis. If they even suspect that the company may be trading while insolvent, they should examine its affairs closely to ensure that there are reasonable grounds to expect that it will be able to pay its debts.” A strong feature of this responsibility is stated:

“It is one thing to trade with shareholders’ money. It is another to trade relying on the credit provided by third parties.”

Managing company insolvency

Where a company is facing insolvency, managers need to understand that they cannot allow the company’s assets to fritter. They need to keep them intact as far as possible to meet the company’s debts (*Winkwirth v Edward Barron Development Co Ltd* [1987] 1 All ER 114).

Meeting tax obligations is critical for managing company insolvency

Company managers need to make sure the company meets its taxation obligations to remit deductions or amounts withheld by the company (*Income Tax Assessment Act 1936* [ITAA], Div 9 Pt IV, s 222ANA(1)). The alternative to remitting these amounts is to automatically place in voluntary administration or liquidation. The purpose of the tax provisions is explained by Mullins J in *Deputy Commissioner of Taxation v Coco* [2003] QSC 119:

“The purpose of Division 9 of Pt VI of the ITAA is set out in s 222ANA(1) which is to ensure that a company either meets its obligations under the [Tax Administration Act 1953] relating to the remission of deductions or amounts withheld or goes promptly into voluntary administration or into liquidation. Section 222ANA(2) explains how the division works:

“The Division imposes a duty on the directors to cause the company to do so. The duty is enforced by penalties. However, a penalty can be recovered only if the Commissioner gives written notice to the person concerned. The penalty is automatically remitted if the company meets its obligations, or goes into voluntary administration or liquidation, within 14 days after the notice is given.”

The directors of the company have specific obligations under section 222APB of the *Income Tax Assessment Act 1936* “to cause the company to pay the estimated amount or to go into voluntary administration or liquidation.” (*Joosse v Deputy Commissioner of Taxation of the Commonwealth of Australia* [2003] FCA 1325). The major issue of dispute in the courts is the service of notice. Company managers need to make sure that practices for the checking of mail is effective so that an affidavit evidence can be submitted to the court about the process

in the company to receive a notice from the Commissioner of Taxation (*Joosse v Deputy Commissioner of Taxation of the Commonwealth of Australia* [2003] FCA 1325).

Preserving assets

By carefully managing the company to preserve its assets to meet debts as they fall due for payment, company manager could manage the insolvency process for the benefit of the company as a whole. Managers could control the company's financial position to negotiate suitable arrangements with creditors. Any arrangements would require an expression of confidence that the company will be able to meet all of its debts and not just those owing to a particular creditor. This is necessary to avoid any claims of preference being given to particular creditors if the company subsequently becomes insolvent either by its own action or by the action of another creditor commencing proceedings to wind up the company in insolvency (*Corporations Act 2001*, Ch 5 Pt 5.4).

Knowing the creditors of the company

Company manager need to have a definitive list of creditors so they know the creditors of the company. The Corporations Act does not define creditors for purposes of voluntary administration or at all (*Selim v McGrath* [2003] NSWSC 927). It is possible, in the absence of accurate internal information, "that there will be cases in which creditors are not confined to 'persons appearing on the company's books or otherwise' to be creditors – in other words, that there may be creditors of whom those in charge of the company's affairs are not aware and have no ready means of discovering internally." (*Selim v McGrath* [2003] NSWSC 927) It is possible for a creditor to include a person who has an unliquidated or a contingent claim against the company (*Selim v McGrath* [2003] NSWSC 927; *Brash Holdings Ltd v Katile Pty Ltd* (1996) 1 VR 24).

Accurate information about creditors would assist the administrator of the company. However, section 439A of the Corporations Act can assist the administrator where the details of all the company's creditors are not known with precision. The operation of this provision is described by Campbell J in *John Vouris Re; Epromotions Australia Pty Ltd and Relectronic-Remech Pty Ltd (In Liq)* [2003] NSWSC 702:

"section 439A(3)(a) requires written notice to be given only to 'as many of the company's creditors as reasonably practicable', and an administrator is often someone who has had no connection with the company before being appointed, and so does not necessarily have experience of communicating with the particular creditors that the company has – it is a more achievable task for the administrator to decide concerning which of the company's creditors it is reasonably practicable to put a notice into the post, than to decide concerning which of the company's creditors it is reasonably practicable to actually have a notice put into the post reach them."

Managing insolvency by process of voluntary winding up

A voluntary winding up of the company can be achieved on a resolution of the members of the company (*Corporations Act 2001*, ss 461(1)(a), 491(1)). In this situation, the directors are required to make a declaration of solvency which states that the directors have inquired into the company's affairs and that their opinion is that the company will not be able to pay its debts within twelve months of the passing of the resolution (*Corporations Act 2001*, s 494(1)). The appointment of the liquidator can be made by the company's members (*Corporations Act 2001*, s 495).

The appointment of the administrator is crucial to the company managers continuing to have a role in the business of the company. The administrator needs to be independent of the company meaning that the person appointed administrator of the company must not have previous substantial dealings with the company (*Commonwealth of Australia v Irving* (1996) 19 ACSR 459 at 464-465). In the role of administrator of the company, the person is "obliged to consider not only means to maximise the chances of the company, or as much as possible of its business, continuing in existence (s 435A), but also issues of fairness between the company and its creditors, and between the company's creditors inter se." (*Molit (No 55) Pty Ltd v Lamb Soon Australia Pty Ltd* (1996) 19 ACSR 160). The person must not only be independent but be seen to be independent of the company and independent of each of the company's creditors. This will avoid the appointment of the administrator being exposed to later questioning (*Commonwealth of Australia v Irving* (1996) 19 ACSR 459 at 465).

The issue of independence of the external manager extends to liquidators as well (*Re Biposo Pty Ltd* (1995) 17 ACSR 730; *Re Chevron Furnishers Pty Ltd (No 2)* [1995] 1Qd R 125).

Where a liquidator has been appointed by the company and this is later overturned by creditors who appoint their own liquidator (*Corporations Act 2001*, s 499(1)), the company's directors and members can apply to the court to resolve the issue of conflict between the company and creditors about the appointment of a liquidator (*Corporations Act 2001*, s 499(2)). If no challenge is made in court, the liquidator appointed by the creditors will be the liquidator of the company.

Management of company insolvency can be reduced or lost

Once an order is made by a court to wind up a company, the powers of directors are suspended (*Corporations Act 2001*, s 471A(1)). Directors and other senior company officers are not removed from office in this situation. However, they cannot purport or actually exercise functions and powers as company officers (*Corporations Act 2001*, s 471A). They can only do so with the approval of the liquidator (or provisional liquidator) (*Corporations Act 2001*, s 471A(1A), (2)).

A residual power remains in company officers to give instruction to legal representatives to oppose an application for an order to appoint a liquidator by the court, to vary the order or to appeal the order (*Re Rick Wilson Pty Ltd and the Companies Act (1982)* 7 ACLR 354; *Anfrank Nominees Pty Ltd v Connell* (1989) 1 ACSR 365).

Managing company insolvency by appointing an administrator

Managing corporate insolvency can also be achieved by appointing an administrator to the company with the purpose of the company entering into a deed of company arrangement with its creditors (*Corporations Act 2001*, Ch 5 Pt 5.3A). It needs to be understood by company managers that the scheme for appointing an administrator to the company and later appointing an administrator under a deed of company arrangement is “to put the future of a company under administration in the hands of its creditors” (*Kaye v National Investment Institute Pty Ltd* [2004] FCA 100). But that does not necessarily exclude company managers from having a role under supervision in the processes.

The administrator would take over the responsibility for the company with the purpose to trade the company out of its financial difficulties. The scheme is appealing as an alternative to winding up the company where the company has a chance to continue to exist or as much of its business will continue to exist, or there would be better returns to creditors and members of the company.

The administrator is appointed by the company’s directors by a resolution of directors stating that they hold the opinion that the company is insolvent or that the company will become insolvent at some future time and that an administrator be appointed (*Corporations Act 2001*, s 436A(1)). The appointment of the administrator is intended to be short as the voluntary administration scheme intends for the administrator to quickly decide if the company and its business is beyond rescue (*Patrick Stevedores Operations No 2 Pty Ltd v Maritime Union of Australia [No 3]* (1998) 159 CLR 1).

During the period that the administrator is in office to manage the company’s affairs, the powers and functions of directors and other company officers are suspended. However, the administrator can give written approval to company officers to exercise powers and perform functions of their offices (*Corporations Act 2001*, s 437C).

The administrator will form an opinion of the company’s affairs after a thorough investigation to advise on whether the company and its creditors should enter a deed of company arrangement, to end the administration or to wind up the company (*Corporations Act 2001*, s 348A). The process is recently described by Goldberg J in *Kaye v National Investment Institute Pty Ltd* [2004] FCA 100:

“The nature of an administration under Pt 5.3A of the Act is that a relatively expeditious decision is to be made by the creditors as to whether there is a basis for maximising the chances of the company continuing to operate or, if that is not possible, having the company administered in a way which brings about a better return for creditors by having the company continue under administration than would result if the company is put into liquidation: *cf* s 435A of the Act.”

It should be noted that there would need to be persuasive evidence to show that there are assets to produce a larger dividend to creditors of the company or at least an accelerated dividend (*Creevey v Deputy Commission of Taxation* (1996) 19 ACSR 456; *Re First Netcom Pty Ltd* (2000) 35 ACSR 615; *Deputy Commissioner of Taxation v Bradley Keeling Management Pty Ltd* (2003) 44 ACSR 377). It appears that the court will apply this principle to issues involving whether or not to place the company in voluntary administration, to maintain this situation or to wind up the company (*Lubavitch Mazal Pty Ltd v Yeshiva Properties No. 1 Pty Ltd* [2003] NSWSC 535).

When a deed of company arrangement is executed, the administration ends. The administrator can then be appointed the administrator under the deed of company arrangement. The nature of the deed is to change the status of the company to a company under a deed of company arrangement and the deed is binding on all creditors who have claims against the company on or before the date of the deed. The deed also revives the powers of directors and other company officers. However, the administrator has ultimate responsibility for the management of the company (*Cresvale Far East v Cresvale Securities* (2001) 37 ACSR 394; [2001] NSWSC 89).

The outcome of the deed of company arrangement can be altered by a resolution of creditors to vary or terminate the deed (*Corporations Act 2001*, s 445C, 445D, 445F). This may affect the ability of directors and other officers of the company in the exercise of powers and functions. On completion of the terms of the deed of company arrangement, company officers are again in control of the management of the company. The experience of the voluntary administration process will enable the directors and other company officers to restructure and recapitalise the company and strengthen the culture and corporate governance processes and procedures to manage the company profitably. The company is then returned “to the mainstream of commercial life” (*Blacktown City Council v Macarthur Telecommunications Pty Ltd* [2003] NSWSC 883).



About Ian Tunstall

Ian Tunstall is a lawyer practising as a solicitor in New South Wales, Australia. He is also an economist and practises through TUNSTALL Consulting Pty Limited.

Ian writes on legal and regulatory issues, involving both law and economics. He is known for expressing law and economics clearly to help readers irrespective of their experience of the subject matter. A catalogue of publications written by Ian Tunstall can be viewed on his website.

Address

16 Orient Street
PO Box 91 Lawson NSW 2783
Australia

Telephone +61 (02) 4759 2641

Fax +61 (02) 4759 3013

Mobile + 61 (0) 414 481 555

Email tunstall@pnc.com.au

Web www.iantunstall.com

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