

BUSINESS LAW GUIDEBOOK

SECOND EDITION

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CHAPTER 12: BANKRUPTCY AND CORPORATE INSOLVENCY

TEST YOUR KNOWLEDGE

1(a). Outline the aims of bankruptcy law. (b) Explain who can be made bankrupt.

ANSWER

(a) Bankruptcy law is designed to meet the case of an individual who has no reasonable prospect of being able to pay his or her debts. The aims of bankruptcy law are therefore:

- to distribute the debtor's property among his or her creditors in the most expeditious and economical manner in accordance with the provisions of the *Bankruptcy Act 1966* (Cth)
- to investigate the conduct and affairs of the debtor
- to give the debtor a new and fresh start in life freed from the demands of creditors.

(b) Only natural persons can be made bankrupts. Partners in a partnership arrangement such as an accounting or law firm can be made bankrupts, but not the partnership itself.

2. Explain the function of a bankruptcy notice.

ANSWER

A bankruptcy notice is a notice that is served on a debtor requiring the payment of a judgment debt. A debtor who fails to comply with a bankruptcy notice commits an act of bankruptcy and can be made a bankrupt.

3. State the requirements that must be satisfied before a creditor can issue a creditor's petition against a debtor.

ANSWER

A creditor's petition may only be presented against a debtor if the amount owing is a minimum of \$5000. This may be the sum of two or more debts owed to two or more creditors: s 44.

4. Once issued, what does a creditor's petition require a debtor to do? Give an example of an act of bankruptcy.

ANSWER

Once a creditor's petition has been issued, the court makes a sequestration order and the debtor becomes bankrupt. The debtor is then required to allow his or her assets to be vested in the Official Receiver or the Trustee in Bankruptcy with some minor exceptions. Sections 73–76 of the *Bankruptcy Act* provide that after a sequestration order has been made or a bankruptcy has occurred as the result of a debtor's petition, a bankrupt may make a proposal to the creditors for a composition in satisfaction of their debts or a scheme of arrangement of their affairs.

It is an act of bankruptcy for debtors to change their place of residence, move from the usual place of business, and refuse to see callers with the intention of defeating or delaying their creditors.

5. Explain what insolvency means? Is there any difference between bankruptcy and insolvency?

ANSWER

Insolvency is the inability of a company to pay debts as they become due and payable. A company is insolvent if it is experiencing an acute shortage of working capital. Bankruptcy proceedings are only brought against individuals, whereas insolvency proceedings are brought against companies.

6. What is the effect of voluntary administration on creditors?

ANSWER

Voluntary administration provides the company with breathing space while its future is being resolved. When the company is in voluntary administration, unsecured creditors cannot enforce their claims against the company without the consent of the administrator or the court's permission. Secured creditors cannot, except in limited circumstances, enforce their charge (security) over company property.

7. Discuss briefly the features of deeds of company arrangement.

ANSWER

Deeds of company arrangement are agreed upon by the creditors in a voluntary administration. Such a deed may have one of the following features:

- (a) a moratorium under which the company is given extra time to pay its debts accrued before the commencement of voluntary administration
- (b) a compromise whereby the creditors agree to accept payment of a lesser amount in the settlement of the company's debts
- (c) a combination of a moratorium and compromise with creditors
- (d) an orderly sale of all the company's property over a period of time that was mutually agreed.

8. Explain what is meant by saying that receivership is a form of external administration.

ANSWER

Receivership is a form of external administration in that it involves the appointment of an independent insolvency practitioner. Where a receiver is appointed by secured creditors of a company, for example, the receiver's duty is to take possession of the secured property, sell it, and out of the proceeds repay the secured debts owed: *Corporations Act* ss 416–434.

9. What are the aims of liquidation?

ANSWER

Liquidation (also known as winding up) is an orderly process under which a company's affairs are wound up, its property is sold, debts owed to creditors are repaid, and any surplus is distributed among its shareholders in accordance with the company's

constitution. In a winding up process which brings a company's existence to an end, a liquidator is appointed by the creditors and control of the company passes to the liquidator.

10. What are the effects of winding up a company?

ANSWER

The company continues to exist as a legal entity after winding up commences. However, it is prevented from carrying on business after the winding up order except for the purpose of winding it up. The company's property continues to belong to it, but its powers to deal with its property are severely restricted: s 468. The directors lose their powers to manage the company's affairs which are controlled by its liquidators who will discharge the company's liabilities in preparation for its dissolution.

11. Discuss the powers and duties of:

- a receiver
- an administrator
- a liquidator.

ANSWER

A receiver is a person who is appointed by secured creditors or the court to investigate the affairs of a company that has run into financial problems. A receiver has the power to do what is necessary to be done for or in connection with the fulfilment of the objectives for which the receiver was appointed.

An administrator is a person who is appointed in a voluntary administration to decide whether a company should come under administration in accordance with a deed of company arrangement, be wound up, or revert to normal operation. The administrator must give an opinion on each option and recommend which option is in the best interests of the creditors. In doing so, the administrator attempts to work out the optimum solution to the company's problems.

A liquidator is a person who is appointed in the winding up of a company, to assume control of the company's affairs and to discharge its liabilities in preparation for its dissolution. When a liquidator is appointed, all the assets are gathered together, valued, and then put to auction or sold by private agreement. The liquidator ascertains the liabilities of the company, determines its contracts, disposes of its business, distributes the assets to

creditors and any surplus to the proprietors, and brings about the dissolution of the company as a legal entity.

12. Explain briefly the different kinds of winding up or liquidation under the *Corporations Act*.

ANSWER

The *Corporations Act* provides that a company may be wound up or liquidated: (a) voluntarily, that is, by its own choice; or (b) compulsorily, that is, against its will.

- (a) where a company has served its purpose, the members of the company may decide to terminate it. The members would hold a meeting and decide to wind up the company. Such a winding up will take place under the control of the members if solvent and under the control of creditors if insolvent.
- (b) where a company is in debt to a creditor of the statutory minimum amount of \$2000, and the debt is due and payable, the court may order that the company be wound up in insolvency on the application of the creditor. The court may only grant leave (where leave is required) if it is satisfied that there is a prima facie case that the company is insolvent.

13. What is the effect of appointing a voluntary administrator?

ANSWER

The effect of the appointment of a voluntary administrator is to give the company a 'breathing space' while its future is being determined. During the period of voluntary administration, unsecured creditors are not able to enforce their claims against the company unless they have the consent of the administrator or the court; and secured creditors cannot enforce their security over company property except in only limited circumstances. The voluntary administrator has all the powers of the company and its directors, including the power to sell or close down the company's business or sell individual assets in the lead-up to the creditors' decision on the company's future.

PROBLEM QUESTION

Before you attempt the following problem, make sure you read the 'Guidelines for answering problems' and be acquainted with the IPAC method of writing answers to problem questions.

PROBLEM

Celia owns a restaurant in the city. Because of escalating rentals and a fall in demand for the kind of food she sells, her business costs have increased. She owes \$60,000 to a number of suppliers and seems unlikely to pay the debts of the business as they fall due. Celia is worried about the insolvent position she is in. She wants to know if there is any alternative to bankruptcy that may apply in her situation. Advise Celia.

ANSWER

The issue concerning the alternatives to bankruptcies for Celia requires a consideration of the following:

- an understanding of the arrangements that can be made with creditors under Part IX of the *Bankruptcy Act* where the debtor does not become bankrupt
- an understanding of the arrangements that can be made with creditors under Part X of the *Bankruptcy Act* where the debtor does not become bankrupt. **(Issue)**

Celia may consider that an alternative to becoming a bankrupt is to enter into an arrangement under Part IX of the *Bankruptcy Act*. Celia may, under Part IX, enter into a debt agreement with the creditors for repayment of the debt due to the latter. The proposal for a debt agreement is directed at the Official Receiver, who then consults with the known creditors, by way of written communication or a calling of a meeting. A defined majority of the creditors must agree to the proposal to proceed further. The proposal could suggest, for example, the payment of less than the full amount of all or any of the debtor's debts, a moratorium on payment, or periodic payments out of income.

Celia may also consider that another alternative to bankruptcy is to enter into an arrangement under the new Part X of the *Bankruptcy Act*. The debtor prepares a statement of affairs and proposal, and within 10 days signs an authority for a registered trustee, solicitor or the Official Trustee to call a meeting of creditors and to take over control of the debtor's property. When the authority is signed, the debtor's property is under the control (but not the ownership) of the trustee. **(Principle)**

The new Part X is a formal alternative to bankruptcy and would be ideal for Celia. If applied, it would become a binding arrangement between Celia and her creditors for the payment of outstanding debts. It requires Celia, the debtor, to provide a 'personal insolvency agreement' (PIA). The arrangement contains a debtor's proposal which gives the creditors a clear picture of what they are being asked to accept by the debtor. Part X includes increased disclosure requirements in respect of the information which a debtor has to provide to the creditors. **(Application)**

In conclusion, when considering the alternatives to bankruptcy as discussed above, it appears the new Part X would be more suitable to Celia's circumstances. Creditors do not have access to after-acquired property. Part X gives Celia a chance to trade out of her difficulties. It is a simpler procedure to administer than bankruptcy, and has more flexibility. Part X arrangements avoid the stigma, restrictions and liabilities of bankruptcy. **(Conclusion)**