Liquidation

Index
Objectives of liquidations
Initiating each type of liquidation
Effect of liquidation
Assets available to liquidator
Voidable transactions
Insolvent trading
Voidable charges
Reports and meetings
Dividends
Set off
Termination of liquidation

OBJECTIVES OF LIQUIDATIONS

The laws of company liquidation originate from long-standing bankruptcy laws. The objectives of bankruptcy are, therefore, preserved and adapted for corporate entities. The objectives of liquidation are to:

- provide a means to terminate or wind up the affairs of a company including its business;
- prescribe a procedure for an orderly realisation of a company's assets;
- ensure the fair and equitable distribution of a company's assets to creditors and, where a surplus exists, to the company's shareholders;
- permit an independent investigation of the company's activities and the conduct of its directors with regard to the circumstances that lead to the company's liquidation;
- undertake the final step of ending the company's existence by attending to its dissolution (termination).

Historically there is no distinction between the phrase "winding up" and the word "liquidation". Practitioners and the Courts use these terms interchangeably.

The Law
Liquidations are generally regulated by Acts of all State and Federal Parliaments, which are collectively known as the Corporations Act ("The Act").

INITIATING EACH TYPE OF LIQUIDATION

The various types of liquidations are detailed below:

Name:	**Commenced:**
Members' voluntary liquidation (MVL)	Voluntarily by directors and shareholders
Creditors' voluntary liquidation (CVL)	Voluntarily by directors, shareholders and creditors
Official liquidation (OL)	Compulsory Court order
Provisional liquidation (PL)	Compulsory Court order

The procedures to initiate each type of liquidation are discussed below.

Members' Voluntary Liquidation (MVL)
The members (shareholders) of a company may voluntarily place a company into liquidation without Court intervention, by passing a special resolution at an appropriately convened meeting of members. The subsequent liquidation is known as a members' voluntary liquidation.

The procedure requires that the company's directors make a declaration of solvency stating they have formed the view that the company will be able to pay its debts in full within 12 months of commencement of the members' voluntary liquidation.

The liquidation has effect as at the time of passing the special resolution.

If an application to wind up the company has been filed with the Court, the members are prohibited from passing the resolution.

MVL and Appointment of Liquidator
At a meeting of members, the members determine by resolution who will be the liquidator of the company.

MVL and Insolvency of Company
If the liquidator of a members' voluntary liquidation forms the opinion the company will not able to paying all creditors' debts in full, the liquidator must attend to one of the following:
1. Apply to Court to wind up the company;
2. Appoint a voluntary administrator;
3. Convene a meeting of creditors to convert the administration into a creditors' voluntary liquidation.

Creditors Voluntary Liquidation (CVL)
Despite its misleading name, creditors cannot initiate a creditors' voluntary liquidation.

Where it is determined by directors that a company is insolvent and should be wound up voluntarily, the following steps must be taken:
1. Directors convene separate meetings of members and creditors;
2. The meeting of members must, by special resolution, pass a motion to liquidate the company;
3. Members will also nominate a liquidator for this purpose;
4. A meeting of creditors must be convened immediately following the members meeting;
5. At the creditors' meeting, the creditors may replace the liquidator nominated by the members.

From Voluntary Administration to CVL
Where a company is subject to a voluntary administration creditors may, by ordinary resolution, vote to liquidate the company at a meeting convened for the purpose of determining the company's future.

The voluntary administrator is deemed to have been chosen as liquidator by the creditors and members.

Official Liquidation
The Court has the power to force a company into liquidation. Compulsory liquidation is commenced by lodging a petition (or application) with the Court for a winding up order.

Where a winding up order is made, the liquidator appointed will be an officer of the Court and is known as an official liquidator.

Official Liquidation: Application to Wind up
The following may make an application to Court for a winding up order:
- The company;
- A creditor;
- A shareholder;
- A director;
- A liquidator (voluntarily appointed) or provisional liquidator;
- The Australian Securities and Investments Commission; or
- A prescribed agency.

Grounds to Apply for an Official Liquidation
The Act specifically divides the grounds that will be available to an applicant into two types as detailed below:
1. An application based on the company's insolvency;
2. Other general grounds including:
   i) company passed a special resolution to wind up;
   ii) company has failed to commence or has suspended its business;

iii) company has no shareholders;
iv) directors acted in their own interest;
v) discriminatory conduct against shareholders; or
vi) just and equitable grounds.

Official Liquidation: Application Due to Insolvency
Creditors make approximately 90% of applications to wind up companies. As the applicant, the creditor must discharge the onerous obligation of establishing that a company is insolvent.
Insolvency can be proven as follows:
- Analysis of the company's accounts, which is not normally available to creditors;
- Reliance by creditor on a statutory presumption of insolvency.

Official Liquidation: Presumption of Insolvency
Subject to the prescribed time period, a Court may presume a company is insolvent if:
- a company failed to comply with the statutory demand;
- a sheriff returned from execution of a levy either wholly or partially unsatisfied;
- a receiver was appointed to the company.

Official Liquidation: Statutory Demands
A statutory demand has the effect of giving a company an ultimatum of "pay up or be wound up". A judgment debt does not need to be obtained before sending a company a statutory demand.
The procedural requirements to obtain a statutory demand include:
- a minimum debt of $2,000;
- the prescribed form (form 509H);
- an affidavit by the creditor stating the debt is due and payable;
- a requirement to pay within 21 days of service of the demand.

Official Liquidation: Defending a Statutory Demand
A company that receives a statutory demand may apply to the Court for an order setting aside the statutory demand.

An application must be made within 21 days after the date the statutory demand is served on the company.

Where a company fails to make this application, a presumption of insolvency will be established. It is open to the company to rebut the presumption of insolvency at the hearing for the winding up order. However, this will require evidence of solvency, which typically will include an analysis of its financial statements together with its cash flow position.

Provisional Liquidation
The Court may appoint an official liquidator provisionally after a winding up application has been filed, but before that application has been determined.

The provisional liquidator's powers will be determined in the Court order making the appointment. Generally the same powers available to an official liquidator will be conferred upon the provisional liquidator.

The Court will make appointments only if there is an urgent need for the independent control of assets.

EFFECT OF LIQUIDATION

The effects of liquidation include the following:

- The liquidator takes control of property;
- The liquidator becomes solely responsible for the management of the company and acts as agent for the company;
- The liquidator shall terminate the business except to the extent that the liquidator believes that it will assist the beneficial disposal of the business or company assets;
- There is a general prohibition on disposal of property and transfer of shares (s.468);
- Existing contracts including employee contracts will generally terminate upon notice of liquidation.

Effect of Liquidation on Directors

The affects of liquidation on directors include the following:

- The powers of existing officers cease;
- Required to provide financial information to the liquidator;
- Required to deliver all property including books and records to the;
- Attend and assist the liquidator as required;
- Attend public examination if convened;
- Exposure to claims for:
  i) insolvent trading;
  ii) indemnity to ATO by directors if ATO repay a preference to a liquidator;
  iii) breach of directors duties;
  iv) voidable transactions including preference and uncommercial payments;
  v) entering into transactions to avoid employee entitlements.

Taxation debts

From 1 July 1993 the priority repayment of taxation liabilities was revoked. Subject to rare exceptions, outstanding tax debts including penalties (excluding Court penalties) are now treated just like any other trade creditor.

It is for this reason that a deed of company arrangement is sometimes looked upon by directors as a remedy to the claims by the ATO and on occasion resisted by the ATO.

Directors should be advised the Income Tax Assessment Act has provision to make a director personally liable for failure to remit tax to the ATO. A precondition of this personal liability is the service of notice to directors, prior to liquidation, stating the ATO's intention and detailing the options for the director to avoid the imposition of personal liability.

The Corporations Act also provides that a director may be personally liable to indemnify the ATO if it is compelled to repay a preference payment to a liquidator.

Effect of Liquidation on Creditors
The effects of liquidation include an automatic stay on creditor proceedings (s.471B). Secured creditors may be exempt from this limitation.

ASSETS AVAILABLE TO LIQUIDATOR
The property available to a liquidator includes the following:

- Property owned by the company as at the date of liquidation;
- Any disposition of property by the company made after the commencement of the winding up;
- All property and income accrued by the company after the date of liquidation;
- Property recoverable pursuant to the voidable transaction provisions of the Corporations Act including:
  i) the proceeds of execution;
  ii) uncommercial transactions;
  iii) transactions for the purpose of defeating creditors;
  iv) unfair preferences;
  v) unfair loans;
  vi) related entity benefits;
  vii) voidable floating charges;
  viii) director's duty to prevent insolvent trading;
  ix) holding company liability for a subsidiary's insolvent trading;
  x) breach of director's duties;
  xi) voidable charges.

VOIDABLE TRANSACTIONS
One of the objectives of the Corporations Act is to ensure that all creditors are treated equally. To achieve this objective the Act provides a framework, which can invalidate transactions that have the effect of preferring one creditor over the other creditors. The unfair transactions that may be set aside by a liquidator are known as the voidable transactions.

Voidable transactions can be defined to include the following types of recoveries available to a liquidator:

- Unfair Preference;
- Uncommercial transaction;
- Fraudulent transaction;
- Unfair loan.

Relation Back Date
The relation back date is the date when the company is deemed to be insolvent.
This date is determined as outlined below:

- If the company was wound up by a Court; the date the application was filed to wind up the company; or

- If the company entered administration or liquidation voluntarily; the date of that resolution.

Unfair Preference
A transaction (including a payment by an insolvent company to a creditor) is an unfair preference if:

- The company and an unsecured creditor (or a third party) enter into a transaction where the creditor is:
  i) paid;
  ii) receives payment by a transfer of property; or
  iii) obtains some form of security; and
- The benefit received by the creditor from the transaction is greater than the amount the creditor would be paid by a liquidator if the transaction was set aside and the creditor proved for the debt in a winding up; and
- The transaction was made during the relevant period (see below).

Recovery of an Unfair Preference
To recover an unfair preference the liquidator must establish:

- the company was insolvent or becomes insolvent because of entering into the transaction; and
- the transaction was effected during the relevant period.

The Relevant Period
Normally the time period available for recovery of a voidable preference is limited to the 6 months preceding a date known as the relation back date. (see above)

If an unfair preference was given to related party, the relevant period is the 4 years preceding the relation back date.

A Related Party
A related party includes a transaction with:

- A director;
- Their spouse or defacto;
- The parent, son, daughter of a director or spouse;
- An entity one of the above control.

Uncommercial Transaction
An uncommercial transaction is any transaction that a reasonable person in the company's circumstances would not have entered into. The Court will consider:

- The benefits;
- The detriment;
- Respective benefits to other parties; and
- Any other relevant matter.

An uncommercial transaction will be voidable against a liquidator if:

- The company was or becomes insolvent because of the transaction;

- The transaction was entered into during the 2 years ending on the relation back day (or 4 years preceding the relation back day if the transaction involves a related party).

Fraudulent Transaction
Where the purpose of the transaction was:
- to enter into an uncommercial transaction or unfair preference;
- to defeat delays or interfere with the rights of any creditor.

That transaction will be voidable if it was entered into during the 10 years preceding the relation back date.

Unfair Loans
A loan to a company is unfair if the interest or charges on the loan was or has become extortionate.
The Court will consider:
- Lender's risk;
- Value of any security;
- Term of the loan;
- Payments and repayments;
- Any other relevant matter.

There is no time period that limits an action to set aside an unfair loan except for the necessity that a liquidator commences the action within 3 years of the relation back date.

Defences for Voidable Transactions

A Court will not set aside a voidable transaction if the following is proven:
- The benefit was received in good faith. This is taken to mean receiving payment honestly and without suspecting that you are being paid in full while other creditors will be left unpaid; and
- There were no grounds to suspect the company was insolvent when payment was made; and
- A reasonable person in the same circumstances would not have had grounds for suspecting the company was insolvent.

To establish a defence for an unfair loan, paragraphs 1, 2 and 3 above must be established, together with the following:
- Valuable consideration was paid as part of the voidable transaction; or
- The creditor changed position as a consequence of the voidable transaction.

The Court Order
A liquidator may make an application to Court for an order that the respondent:
- pay the company which the liquidator has control, an amount of money equal to the value of benefit received from a voidable transaction;
- transfer property back to the company; or

- release a debt, which may also be obtained by a liquidator.

INSOLVENT TRADING

A director may be personally liable for the debts incurred by a company that continues to trade when insolvent. The following elements must be proven:

- The person is a director of the company. Directors can be deemed to include any person occupying or acting in the position of a director by whatever name they are called and whether or not they are validly appointed; and
- The person is aware;
  i) there are grounds for suspecting; or
  ii) a reasonable person in the same circumstances would be aware that;
- The company incurs a debt; and
- The company is insolvent or becomes insolvent by incurring the debt.

Note that insolvency is a difficult legal concept that can be easily defined as 'an inability to pay debts as and when they fall due and payable'.

To make a director personally liable for insolvent trading, a liquidator (or a creditor with the liquidator's consent) must make an application to Court for compensation for an amount equal to the amount of the loss or damage incurred.

Holding Company Liability for Insolvent Trading

Where a holding company permits a subsidiary to trade whilst insolvent, the holding company may be made responsible for the subsidiary's debts. The relevant provisions are similar to the provisions for personal liability for directors (detailed above).

Defences

There are 4 defences available to a claim of insolvent trading as detailed below:

1. Reasonable grounds to expect company is solvent

A person may avoid any liability for insolvent trading if they can prove to the Court:

- At the time when the debt was incurred;
- the person had reasonable grounds to expect, and did expect;
- that the company was solvent at the time; and
- the company would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

2. Reliance on third person for details of company's solvency

A person who is sued for insolvent trading may claim they relied upon the advice of a third person who was responsible for accounts of the company.

The elements of this defence are the silent director:

- had reasonable grounds to believe, and did believe the provider of information regarding the company was:
  a) a competent and reliable person;
  b) responsible for providing to the silent director adequate information about the company's solvency;
  c) was fulfilling that responsibility; and

- on the basis of the information provided by the third person, the silent director believed the company was solvent.

3. Did not participate in company's management

It is a defence to a claim of insolvent trading that a person, because of illness or some other good reason, did not take part in the management of the company at the time a debt was incurred and the company was insolvent.

4. Reasonable attempts to prevent insolvent trading

It is a defence to a claim of insolvent trading that a person took all reasonable steps to prevent the company from incurring a debt while insolvent.

VOIDABLE CHARGES

Charges Void Against a Liquidator

A charge will be void if it was:

- not lodged with ASIC within 45 days of creation; unless it was created more than 6 months before the commencement date of liquidation; or
- in favour of an officer of the company (or associated person) and enforced within 6 months of creation.

Floating Charge Created within 6 Months

A charge will be void if it was created within the 6 months* preceding the relation back date unless:

- the company receives a payment, goods, services or some other benefit as consideration for the charge; or
- the company was solvent immediately after the charge was created.

* The exact duration of the "6 month period" referred to above is determined by reference to a date known as the relation back date (def).

REPORTS AND MEETINGS

An underlining principle of the laws of liquidation is that the liquidator acts for the benefit of those parties who are financially interested in the outcome of the liquidation. Typically this is restricted to creditors, but on occasion where there is a surplus of assets shareholders will be financially interested in the outcome.

There are various provisions, which permit creditors to control the liquidation or receive information, these include the following:

- Approval by creditors of the remuneration of the liquidator;
- Liquidator is to "have regard to directions given by resolutions of meetings of creditors";
- The liquidator must convene meetings of creditors as requested.

There is no specific requirement for a liquidator to deliver written reports to creditors. Conversely, a liquidator must report to ASIC.

Typically where assets exist in a company, written reports will be sent to creditors and oral reports will be given by the liquidator at meetings of creditors.

DIVIDENDS
A liquidator must, as soon as practicable, declare and distribute a dividend amongst the creditors whose debts or claims have been admitted.

Proofs of Debt
The liabilities of a company are categorised into provable and non-provable debts.
A provable debt will be eligible to participate in any dividend paid by the liquidator.
The Corporations Act provides that, subject to the exceptions, all debts and liabilities, present, future, certain or contingent that existed as at the commencement date are provable. A debt that is not legally enforceable, or of an uncertain value, will not be provable.

Priority Creditors
Subject to the costs of realisation incurred by a liquidator, a claim by a secured creditor will be paid first. Before making a payment to a secured creditor, the liquidator must review the secured creditor's charge to determine if the charge is a fixed or floating charge.

The liquidator must quarantine the sale proceeds from assets sold subject to a floating charge. The Act provides that employee entitlements must be paid in full before a secured creditor can be repaid from these funds.

Sale proceeds from asset secured by a *fixed* charge may be paid directly to the secured creditor.

Trade creditors are categorised as unsecured creditors. The Act provides that some classes of unsecured creditors shall be paid in priority to other classes of unsecured creditor claims. If there is insufficient money to pay any class of creditor in full those creditors are paid pro rata.

The order of payment of unsecured creditor claims will typically be as follows:
1. Expenses reasonably incurred on behalf of liquidator protecting and realising the assets;
2. If the Court ordered the winding up, the taxed costs of the petitioning creditor;
3. The liquidator's expenses and remuneration;
4. Employee wages and superannuation;
5. Compensation claims;
6. Employee long service leave, annual leave and redundancy.

SET OFF
When a company goes into liquidation and an entity (or person) is both a debtor and a creditor of the insolvent company, it is sometimes possible to set off the amounts so that only a net amount is payable.

Set off enables an entity to avoid paying a liquidator an amount owed to the insolvent company until the amount the insolvent company owes the entity is applied against the

entity's outstanding debt.

Set off is only permitted if the entity and the company in liquidation:
- have debts in existence as at the date of the winding up of the company;
- have entered into what is called mutual dealings; and
- the entity did not have notice that the company was insolvent at the time of entering into any transaction subject to a set off claim.

To set off the following must be considered:-
- The legal capacity of the parties;
- The intentions of both parties;
- The liabilities are commensurate (the same type).

Capacity
To satisfy the legal capacity requirements, set off debts must be of the same legal capacity. A debt due to an insolvent company can only be set off against a payment due from the insolvent company.

A debt payable by a director in his personal capacity cannot be set off against a debt due from the insolvent company.

Intentions
It must be established that the debts to be set off against each other were not independent transactions.

Commensurate Debts
A debt for money (a pecuniary debt) can only set off against a similar debt.
Not all debts can be set off.

Other Issues
Generally, money that is payable to a liquidator as a consequence of a liquidator's preference action cannot be set off.

Similarly, where a shareholder of a company in liquidation is required to pay unpaid capital, set off will not be permitted.

Payments made by an insolvent company's guarantor can be set off against any additional amounts the guarantor owes the insolvent company.

Recently, the Courts held that the insolvent company could set off a debt payable to a liquidator for insolvent trading against amounts payable.

TERMINATION OF LIQUIDATION
Where a liquidation has been finalised the liquidator will dissolve the company's legal existence by process known as deregistration. Deregistration may be undertaken in a number of ways including the following:

- Where a liquidator has available funds the liquidator may apply to Court for a release and deregistration of the company;
- Where there are assets of less than $1000 a liquidator may apply for ASIC to voluntarily commence the deregistration procedure. Thereby ASIC will:
  i) update its database;
  ii) publish a notice in the commonwealth gazette.

A simpler method of initiating deregistration available to a liquidator is to advise ASIC that the liquidator is no longer acting. Thereby ASIC will:

- give notice of its intention to deregister to the company to the liquidator, directors and company;
- update its database;
- publish a notice in the gazette.

Automatic Deregistration

Where a liquidator has been appointed voluntarily, deregistration is automatically effected three months after lodging a final meeting return.