

## The Worrells' Newsletter for June 2006

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### **We Say ..**

At one of our recent breakfast seminars a participant commented on the number of companies that end up in liquidation as a result of using the voluntary administration process and observed that many of these companies had never even put up a proposal for creditors to consider.

The unstated question was whether such companies were making proper use of the voluntary administration legislation or whether they should more properly be using the creditor's voluntary winding up provisions of the Corporations Act.

Perhaps what the participant did not appreciate is that a great many of these companies have directors who place their company in voluntary administration with every intention of proposing a Deed of Company Arrangement. If the company is still trading the directors will probably expect to propose a better return through continued trading; if trading has ceased the incipient proposal is likely to involve contributions from third parties leading to an expected better return to creditors in exchange for avoiding the uncertainty of the liquidation process.

But the voluntary administration process allows the directors to have a breathing space to consider the realities of both the company's and their own financial position and in this they are often aided by observations and guidance from the voluntary administrator. When faced with such realities it is not unusual for the directors to conclude that ongoing trading is impractical or that the demands of secured or guaranteed creditors prohibit making the expected contributions or for some other reason the anticipated proposal is unworkable.

Nevertheless the voluntary administration process is not wasted as it encourages even those directors who end up being unable to make a proposal to creditors to face up to the insolvency of their company and to take the necessary action.

### **Anyone Care to Propose a Deed of Company Arrangement?**

Traditionally it is the directors of an insolvent company who propose the terms of a Deed of Company Arrangement for consideration by creditors. It is true that the voluntary administrators may suggest additional elements of the proposal or add some refinement which is likely to make the proposal more acceptable to creditors or more practical in operation, but the proposal remains that of the directors.

Yet Part 5.3A of the Corporation Act imposes absolutely no limitation on who may propose the terms of a Deed of Company Arrangement. Similarly there is no restriction on the number of deed proposals that may be submitted to creditors for their consideration. Further, the Act appears to give no discretion to the voluntary administrator to refuse to submit any proposal to the creditors, although they may of course recommend against acceptance. It follows that it is quite possible for a meeting of creditors to consider any number of competing proposals.

Once it is recognised that few, if any, restrictions apply in regard to who may lodge a proposal with the voluntary administrator (or what may be contained in the proposal) a number of interesting possibilities emerge. For example:

- The voluntary administrator may themselves submit a proposal. Indeed they might well be under a duty to do so if they feel that the interests of creditors would be better

served by such a course of action.

- In instances where the board is divided, different and competing proposals might be lodged by each camp. Such proposals might well require the removal of the unsuccessful directors from the board, an outcome which the voluntary administrator has the power to effect.
- The directors may collectively submit two alternative proposals and invite the creditors to select the one best suited to them.
- A shareholder might lodge a proposal the terms of which might include the subscription of further trade capital conditional upon the forced transfer of other shareholders holdings and or a change in the make up of the board.
- Any creditor or a committee of creditors might see merit in lodging a proposal which reflects the creditors' wishes, rather than attempting to amend any director's proposal.
- A competitor, who may not even be a creditor of the company, could propose the terms of a Deed. It is not difficult to envisage circumstances where a competitor acquires a business on advantageous terms while at the same time providing a better outcome for staff and creditors.
- Senior management could lodge a proposal reflecting what might otherwise be a management buy out but on terms that take account of the insolvency of the company.

Clearly the interests of the existing shareholders must be considered by a voluntary administrator when making a recommendation for the acceptance or otherwise of a Deed of Company Arrangement, but in our view, it is likely that a court would find that the interests of the creditors are paramount.

If the interests of creditors are best served by a proposal accepted by a meeting of creditors and the directors refuse to execute the Deed the voluntary administrators have the power to do so and thus carry the creditors' wishes into effect.

## **Legislation Highlighted - Section 58**

### **BANKRUPTCY ACT 1966 - SECT 58**

#### **Vesting of property upon bankruptcy-general rule**

When someone is appointed as a trustee in bankruptcy, all of the property of the bankrupt vests in the trustee. Section 58 sets this out fairly clearly. That property may include real property, commonly the bankrupt's home.

*(1) Subject to this Act, where a debtor becomes a bankrupt:*

*(a) the property of the bankrupt, not being after-acquired property, vests forthwith in the Official Trustee or, if, at the time when the debtor becomes a bankrupt, a registered trustee becomes the trustee of the estate of the bankrupt by virtue of section 156A, in that registered trustee;*

*and*  
*(b) after-acquired property of the bankrupt vests, as soon as it is acquired by, or devolves on, the bankrupt, in the Official Trustee or, if a registered trustee is the trustee of the estate of the bankrupt, in that registered trustee.*

Real property requires transmission of the title for the property to vest at law in the trustee. However, even if transmission has not been entered, the property still vests in equity from the date of bankruptcy, and will continue to vest until sold, disclaimed or revested.

*(2) Where a law of the Commonwealth or of a State or Territory of the Commonwealth requires the transmission of property to be registered and enables the trustee of the estate of a bankrupt to be registered as the owner of any such property that is part of the property of the bankrupt, that property, notwithstanding that it vests in equity in the trustee by virtue of this section,*

*does not so vest at law until the requirements of that law have been complied with.*

But what happens when a trustee does nothing with the property for an extended time?

The common example is where there are two owners of the home, the bankrupt and their spouse. There is no equity in the property at the time of bankruptcy, so the trustee takes no action at that time. If the mortgagee takes no action, the bankrupt and spouse can keep living in the property.

Years later some equity accrues from increases in the value of the home and reduction of the mortgage. Does the trustee have the right to then sell the house and realise the equity?

Yes. There will always be special circumstances that need to be considered, but the trustee does not give up the right to their interest in the property simply because they do nothing during the period of bankruptcy.

## **Bankruptcy Legislation Amendment (Anti-avoidance) Act 2006**

The Bankruptcy Legislation Amendment (Anti-avoidance) Act 2006 received Royal Assent on 3 May 2006, with the amendments commencing on 31 May 2006.

The amendments are timely, considering the contents of the April 2006 newsletter which summarised the High Court's undervalued transfers ruling in the *Prentice v Cummins* decision in favour of Mr Cummins' trustee in bankruptcy.

### **Claw Back Provisions**

The amendments strengthen the 'claw back' provisions in the Bankruptcy Act 1966 (the Act). The claw back window in section 120 of the Act (undervalued transactions) for property transferred to a related entity for less than market value has increased from 2 years before a person's bankruptcy to 4 years.

Another amendment will create a rebuttable presumption of the transferor being insolvent at the time of a transfer of property (for the purposes of sections 120 and 121 of the Act) if either the transferor had not kept proper 'books, accounts and records' or did so but somehow lost them. The presumption will only apply to people who are carrying on a business, and, as a presumption, is capable of being rebutted by proving the bankrupt's solvency at the relevant time.

### **Transfers to defeat creditors**

Section 121 is the transfers to defeat creditors section. The amendments are directed to the 'wilful blindness' which some transferees have as to the reasons why the transferor is transferring property to them. Now objective standards of reasonableness will complement the transferee's knowledge of the transferor's intentions. A transferee can now only retain such property to the exclusion of the trustee in bankruptcy if the consideration given was at least market value, they didn't know the transferor was seeking to defeat creditors and they could not have reasonably inferred that defeating creditors was the transferor's main purpose. This last requirement is the addition. Adding an objective criterion like this will reduce the scope for dubious defenses to be raised.

### **Third Party Payments**

A new section 121A of the Act will be inserted. Its effect is to apply sections 120 and 121 of the Act where a transferor transfers property for full market value prior to bankruptcy but directs

the purchaser to pay a third party. If the third party does not on-forward the consideration to the transferor, the loss to the estate can be recovered by the trustee. The amendments deem the movement of consideration to be a 'transfer of property' for the purposes of sections 120 and 121, or 122 as a preferential creditor payment if the third party is a creditor of the bankrupt and the transfer took place in the months immediately prior to bankruptcy.

### **Entity Arrangements**

Changes will occur to Division 4A of Part VI of the Act, the entity division. The entity division allows bankruptcy trustees to obtain property in certain circumstances from entities such as partnerships, trusts or companies that, during the 'examinable period', were 'controlled' by the bankrupt, benefited from his or her personal services, acquired property as a direct or indirect result of the bankrupt's personal services and the bankrupt then used or derived benefit from that property.

The 'control', 'personal services', and remuneration criteria will be replaced by a more forensic test looking towards how the bankrupt made actual contributions towards acquiring property. Also bankrupts will be deemed to have used or obtained benefit from such property even if their use/benefit was indirect only.

Finally natural persons will be included within the scope of the entity division. An example would be where the bankrupt contributed funds to allow a spouse to purchase a matrimonial home but failed to register on the title as a co-owner.

The effect of the changes to the treatment of entity arrangements will not rest with acquisition contributions only; the changes will also allow trustees to claim the value of an entity's interest in property that has increased as a result of a bankrupt's financial contributions.

### **Likely Outcomes**

These, and other recent amendments to the Bankruptcy Act, are directed towards reducing the ability of unscrupulous debtors to abuse the bankruptcy system through creative accounting and 'under the table' deals with friendly third parties. Undoubtedly many trustees will eagerly take advantage of these amendments so as to increase the returns for creditors, who are often the parties who suffer most when persons are bankrupted.

David Topp  
Barrister-at-Law

## **Leadership Article - Summary**

Over the last year we have published a series of articles dealing with the Ten Laws of Leadership. These articles were drawn from the book of the same name by Dr Bill Newman Phd, and it is to that author that all credit is due for the ideas contained in the articles.

Because the articles have generated some considerable interest and fees we have reproduced them in a convenient form the Library section of our web site. Feel free to use the attached link.

## **Severing a Joint Tenancy - Void or Not? Part 5**

Readers of this Newsletter will recall a series of articles by the same name that started in June 2004. The last article in the series was published in September 2005.

The summary is that we took an action under section 121 of the Bankruptcy Act to recover a

share of a property that was severed (joint tenancy to tenants in common) before bankruptcy, where the non-bankrupt co-owner had a terminal illness. We hold the position that the transfer was undertaken to defeat an interest in the property that would have accrued to creditors through the right of survivorship when the co-owner died.

The Federal Magistrate thought that we were correct. The Federal Court on appeal did not. We were deciding whether to seek special leave to appeal to the High Court when the last article was written.

We sought and got special leave. Interestingly the Chief Justice joined the bench for this application. We are before the High Court on June 20. We will let you know of the result when it comes down.

## **Financial Statements - Fact or Fiction - Revenues**

This third article in our financial statement series deals with revenues. Two major and very obvious circumstances occur with revenues:

- (a) They are overstated; or
- (b) They are understated.

### **When are revenues overstated?**

Every business has a time when revenue can be considered as "earned" and properly entered into the books. This time does not always coincide with what accounting standards suggest, and this leads to revenues either being recorded earlier than they should be, or later than they should be. In most cases it is earlier than it should be, and usually it is for the bank's benefit to get or keep funding.

Occasionally we see examples of revenue being brought to account prematurely to bolster bonus payments, under-performance, or to hide fraud.

By far the most common occurrence is recording revenue before any work has been done or a sale has been made. An example of this is recording a revenue at the time when an order is placed and before any work has been done. The other side of the double-entry is in the debtors' ledger, and we spoke about that side of the entry in an earlier article.

Other circumstances are:

- (a) recording the supply of goods on consignment as sales;
- (b) not recording the return of goods;
- (c) recording sales at a time when the goods are supplied on a Sale or Return basis
- (d) bringing the next period's sales into this period to bolster this period's numbers

Some of these actions may be done out of ignorance or hope that transactions will be complete. Some may be an attempt at financial statement fraud. All misstate the position of the business.

From an insolvency practitioner's point of view, it can make it difficult to sell a business as a going-concern or recommend a proposal for a deed of company arrangement or personal insolvency agreement.

### **Why would revenues be understated?**

Three main reasons:

- (1) to lessen tax payable in a period;
- (2) to hide the receipt from the sale;
- (3) inadequate bookkeeping.

Sometimes sale are delayed until the next period to lessen tax payable in the current period. If the business owner is doing this, they will usually bring in the cost of the sale into the current period to increase expenses.

Sometimes when the business is heading towards insolvency, sales will be made and not recorded so that the revenue from those sales can be diverted. This is essentially stealing the sale from the business and is more prone in cash businesses.

At other times revenue is not recorded simply because the focus is on making sales, not the bookwork. If the business is in financial difficulty, the business owner's efforts are usually focused on saving the business through generating sales. What is forgotten is that the money from the sales has to be collected, and to do that, it needs to be recorded.

One example highlights the issue. A small business appointed us as administrators due to insolvency caused by a complete lack of cash. We were told that trading was quite good, but the figures looked terrible. We quickly discovered that most of the jobs completed (over \$100,000 in total) had never been invoiced. This meant that:

- (a) They were not recorded as sales, making revenue look small; and
- (b) they were not able to be collected as the invoices had not been processed.

Taking care of that one issue meant that the company could propose a deed of company arrangement and the business could be saved. How did the problem occur in the first place? The owner was a great tradesman, and had no idea about bookkeeping. It was solved by employing a bookkeeper.

*Next month: Expenses*

## **Directors Penalty Notices: Part 2**

Last month's Newsletter contained an article titled: Directors Penalty Notices: 14 Days to Act; Starting When? Leigh Adams of Leigh Adams Lawyers has kindly allowed us to reproduce part of a paper he recently prepared on this topic.

### **Service of Notices**

Personal service is not required. What about if a director or a past director argues that his non-compliance with a Director Penalty Notice was because he never received it by post?

Section 222AOF provides for a presumption in regards to service of Director's Penalty Notices. A director or past director is served with a Director's Penalty Notice by the DCT delivering it to the address stated for that director in an Australian Securities and Investments Commission (ASIC) search carried out just prior to service. To obtain the benefit of the presumption of service, all the DCT has to do is prove that the Director's Penalty Notice was posted in an Australia Post box in a stamped addressed envelope, addressed to the director at the address stated in the recent ASIC search - see DCT -v- Gruber (1997-1998) 43 NSWLR 271 at 276G.

It is extremely unlikely for a past director to advise ASIC of his change of address, but this is where problems start to arise. In DCT -v- McCarthy (District Court of NSW, unreported, Andrews

ADCJ 14 June 2002 and 17 October 2002), service was presumed against the director despite the director's obvious non-receipt of the notice caused by his subsequent move.

The likelihood of this occurrence arising increases of course with the passing of time. The DCT can serve a Director's Penalty Notice years after a director's resignation. It can be for process unremitted group tax of the company that predates his resignation. The absence of a statute of limitations for the Commonwealth, or any relevant time bar in the ITAA means that this problem could haunt past directors for many years after their departure. This has been the subject of judicial comment by Heydon JA (as he then was) in *DCT-v-Saunig* (2002) 55 NSWLR 722 at 735.

The only effective mechanism to prevent this problem occurring is to have the company wound up or have an administrator appointed to it, thereby remitting the penalty under s222AOG. However, it is not uncommon that a company may struggle on for years without remitting all its deductions of group tax before it is placed in the hands of a liquidator or administrator.

In addition to the above legislative benefits favouring the DCT, there is no time bar on when the DCT can commence proceedings after "serving" a Director's Penalty Notice.

Conceivably, a Director's Penalty Notice could be served by posting it to an ASIC noted address for a past director (who was a director at the relevant time to attract a liability), but long after the company is wound up, proceedings could then be commenced for recovery based on non-compliance with the Director's Penalty Notice. The first the director would know about the matter would be upon being personally served with a statement of claim or other originating court process.

And that's not all. The DCT also has the benefit of the evidentiary presumption contained in the Evidence Act and the Acts Interpretation Act to presume a time when the Director's Penalty Notice is placed in the post office box. S163(1) of the Evidence Act (Cth) provides that a letter from a Commonwealth agency addressed to a person at a specified address is presumed to have been sent on the fifth business day after the date on which the letter was prepared.

The Evidence Act and the Acts Interpretation Act also have evidentiary presumption as to the time when a Director's Penalty Notice is received by prepaid post at the director's address - S160 of the Evidence Act provides that a postal article sent by prepaid post addressed to a person at a specified address is received on the 4th working day after having been posted. Section 29 of the Acts Interpretation Act (1901) (Cth) provides for an alternative presumption.

Accordingly, it can be seen that the DCT has an advantage in regards to service. However, the objects of Part 9 are not going to be necessarily achieved by sending a Director's Penalty Notice to a redundant address.

The objects of Part 9 are set out in s222ANA. See also the Second Reading Speech of Senator McMullan, the Member of Parliament introducing the relevant Bill, which was the Insolvency (Tax Priorities) Legislation Amendment Bill (1993) (Cth), in Parliamentary Debates (Cth) Senate 19 May 1993 at 880. The objects are to have the company meet its group tax obligations or to have control of the company (that is arguably insolvent) taken out of the hands of the board of directors by the appointment of an administrator or a liquidator. Actual service on existing directors may achieve that result but serving the notices to an ex-director at his old address is unlikely

In *Miller-v- DCT* (1997) 27 ACSR 533, it was held that as the function of the penalty notice is to provide a final warning to the recipient of the notice, the Commissioner was not entitled to commence proceedings until the 14 day period after receipt of the notice had expired.

In this instance Mr Miller was successful in his appeal against summary judgment as the ATO commenced proceedings prematurely. However, the Commissioner was able to commence fresh proceedings if it wished to do so. No prizes for guessing what happened.

In the McCarthy case, an extension of time for compliance granted by an employee of the ATO to the taxpayer was upheld by a single judge in the District Court, on the basis that Section 8 of

the Taxation Administration Act gave the ATO administrative functions which extended to allowing such further time for compliance with a DPN. However, there is authority to the contrary.

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