

Chapter 2

The Bill in the context of current insolvency law

Background

2.1 The origin of this Bill lies in the collapse of the telecommunications carrier One.Tel in May 2001. Shortly after One.Tel was placed into administration it was reported that the company's co-managing directors, Mr Keeling and Mr Rich, had each received approximately \$7 million in bonuses from the company in a year in which it had incurred substantial losses. In response to public concerns about the circumstances surrounding the collapse of One.Tel and the payment of bonuses to its directors, the Prime Minister announced on 4 June 2001 that:

The Commonwealth intends to amend the law so that in future, where bonuses are paid in the circumstances where those bonuses were paid to the bosses of One.Tel, that money will be refundable and can be used to meet the lawful and legitimate entitlements of workers and also the other creditors of the company.¹

2.2 Other inquiries have brought to light inappropriate transactions between companies and their directors.²

2.3 The Bill permits liquidators to reclaim unreasonable payments made to directors of companies that are subsequently put into liquidation.

Voidable transactions

2.4 Insolvency law has long adopted a policy of setting aside transactions in which an insolvent company disposes of property or makes payments to particular creditors within a relevant period of time prior to the commencement of formal insolvency. A debtor may be placed into external administration months or sometimes years after recognizing that this outcome is inevitable. In anticipation of the formal commencement of insolvency proceedings debtors may attempt to hide assets from their creditors, favour certain creditors over others, incur artificial liabilities or make gifts to relatives or friends. Outside an insolvency context some of these transactions may be perfectly permissible. In an insolvency context they may be unfair to the general body of unsecured creditors. The purpose of these laws is to prevent the depletion of the assets of the company through certain transactions entered into within a specified period prior to the winding up.

1 The Hon John Howard MP, House of Representatives, *House Hansard*, 4 June 2001, p 27 127.

2 See, for example, transcripts of hearings of the HIH Royal Commission into the collapse of the HIH Insurance Group, <http://www.hihroyalcom.gov.au/Hearings/Transcript.asp>

2.5 Under the Corporations Act liquidators may recover certain payments made, or reverse certain transactions entered into, by companies in the period preceding the company's liquidation. Division 2 of Part 5.7B deals with those company transactions and payments which may be challenged by a liquidator during the period preceding formal insolvency.

2.6 The provisions, known as the 'clawback' or voidable transaction provisions, permit liquidators to seek court orders reversing certain transactions entered into by an insolvent company in the lead-up to liquidation or, in limited circumstances, in the period prior to the company becoming insolvent. There are essentially four types of transactions which are able to be challenged under the avoidance provisions: unfair preferences, uncommercial transactions, unfair loans and fraudulent transactions.

2.7 The key operative provision is section 588FE which provides that certain pre-liquidation transactions are to be regarded as voidable transactions. Under section 588FE two types of transactions are voidable: insolvent transactions (defined in section 588FC) and unfair loans (defined in section 588FD).

Insolvent transactions

2.8 An insolvent transaction must be either an unfair preference (defined in section 588FA) or an uncommercial transaction (defined in section 588FB). To constitute an insolvent transaction, the company which is in liquidation must either have been insolvent when the transaction was entered into or become insolvent as a result of entering into the transaction. A transaction is not voidable solely because it is an 'insolvent transaction'. Under section 588FE(2)–(5) an insolvent transaction is voidable where, in addition, it is:

- entered into during the six months immediately before the relation-back day (in most cases the day when the application to wind up the company was filed with the Court);
- an uncommercial transaction entered into during the two years immediately before the relation-back day;
- an unfair preference and an uncommercial transaction involving a related entity of the company and occurring during the four years immediately before the relation-back day;
- an unfair preference and an uncommercial transaction entered into during the four years immediately before the relation-back day where the company was a party to the transaction in order to defeat, delay or interfere with the rights of any or all of its creditors (section 588FE(5)).

Unfair loans

2.9 Most payments made by a company prior to a winding up are not generally recoverable by a liquidator unless the company was insolvent at the time it made the payment (or became insolvent as a result of making the payment). However, unfair loans are voidable irrespective of whether the company was insolvent at the time it made the loan. An 'unfair loan' is defined in section 588FD as one where the interest

was ‘extortionate’ at the time when the loan was made or has since become extortionate because of a variation. The explanatory memorandum to the 1992 Corporate Law Reform Act (para 1048) noted in relation to this provision:

The section is not directed to loans which in hindsight may be judged as bad bargains but at transactions which are grossly unfair, so that in normal circumstances no reasonable company is likely to have entered into such a contract unless there were some further rationale such as where the agreement is a sham agreement intended to operate in circumstances of insolvency to confer an undue benefit on the lender.

2.10 The following table summarises the transactions that are voidable under the current law and the time frame in which they are voidable.

Type of transaction	Length of time prior to relation-back day	Section
Insolvent transaction (with a non-related entity)	6 months (or after the relation-back day but on or before the day when the winding up began)	588FE(2)
Insolvent and uncommercial transaction (with non-related entity)	2 years	588FE(3)
Insolvent transaction to which a related entity of the company is a party	4 years	588FE(4)
Insolvent transaction entered into for the purpose of defeating, delaying or interfering with the rights of any or all of the creditors	10 years	588FE(5)
Unfair loan	No time limit	588FE(6)

Unreasonable director-related transactions

2.11 The Bill adds the category ‘unreasonable director-related transaction’ to the list of voidable transactions in section 588FE. The main focus of the bill is on

transactions entered into by the company with its directors but extends to transactions made to, on behalf of, or for the benefit of a director or a close associate of a director.

2.12 Under proposed section 588FDA(1) an ‘unreasonable director-related transaction’ includes payments made by the company, conveyances, transfers and other dispositions of property and issues of securities including options. Incurring an obligation to enter into these kinds of transfers would also be a ‘transaction’ for the purposes of the Bill.

2.13 The Bill targets ‘transactions’ that a reasonable person in the company’s circumstances would not have entered into. Under proposed section 588FDA(2) a transaction will be caught if it may be expected that a reasonable person in the company’s circumstances would not have entered into the transaction having regard to the benefits and detriments to the company of entering into the transaction, the benefits to other parties to the transaction and any other relevant matter.

2.14 The reasonableness of the transaction is determined at the time the payment, transfer or disposition of property, etc occurs and not at the time the company incurred the obligation. A liquidator will be able to recover payments where the unreasonableness of the transaction becomes apparent when the company actually makes the payment even if it appeared reasonable at the time the company incurred the obligation. Where a payment is made to a director or a close associate of a director a court will generally not be required to determine the reasonableness or fairness or otherwise of the obligation incurred by the company when the bargain was struck.

2.15 Under proposed section 588FE(6A) an unreasonable director-related transaction will be voidable where it is entered into or given effect to within four years of the relation-back day.

2.16 Unreasonable director-related transactions will be voidable irrespective of whether the company was insolvent at the time of the payment, transfer or disposition of property occurs or at the time the company incurred the obligation.

2.17 Proposed subsection 588FF(4) restricts the range of orders that a court may make in relation to voidable transactions. The court may make orders only in relation to the unreasonable portion of the total transaction taking into account the reasonable value (if any) that is attributable to it.