LEVEL TWENTY SEVEN CHAMBERS

SOLVENCY/INSOLVENCY

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1. INTRODUCTION

1.1. The concept of solvency and insolvency is relevant to corporations and individuals. It is fundamental to persons who manage corporations and to insolvency practitioners.

1.2. The definitions of the terms 'solvent' and 'insolvent' appear simple, but in practice may be difficult to establish.

1.3. This paper addresses these concepts, the pleading of solvency or insolvency and a number of the issues which may impact on the outcome as to solvency/insolvency.

2. SOLVENCY/INSOLVENCY-STATUTORY DEFINITION

2.1. The term "solvent" is defined in s 9 of the *Corporations Act 2001* (Cth) (Corporations Act) as having that meaning given by s 95A(1). A person is solvent if, and only if, the person is able to pay all the person's debts, as when they become due and payable. The term "insolvent" is defined in s 9 as having the meaning given by s 95A(2). This provides that a person who is not solvent is insolvent.

2.2. Section 95A defines "solvent" and "insolvent" in identical terms as *the Bankruptcy Act 1966* (Cth) (Bankruptcy Act). In 1996, ss 5(2) and 5(3) were inserted in the Bankruptcy Act defining the terms "solvent" and "not insolvent". A person is "solvent" if, and only if, the person is able to pay all the person's debts, as and when they become due and payable: s 5(2). A person who is not solvent is insolvent: s 5(3).

2.3. Prior to introduction of s 95A, the term "solvent" was determined by reference to the debtor's ability to pay debts "as they become due from his or her own moneys". Neither the explanatory memorandum nor second reading speeches identified any legislative intent by the omission of solvent from the definition.

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1 Member of the Institute of Chartered Accountants in Australia and New Zealand. This paper is based upon (and contains extracts from) the work in para [5.10.05] as to the definitions of "Solvent" and "Insolvent" in "Australian Bankruptcy Law and Practice" of which I am a co-author, and which is published by Thomson Reuters (Professional) Australia Limited ABN 64 058 914 668.

2.4. In the context of the Corporations Act provision, it is the predominate position that solvency need not be assessed by reference to the company's ability to pay debts from its own monies as those words no longer form part of the definition: *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608 at [116], affirmed on appeal in *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243 at [107]–[109].

2.5. That approach has similarly been applied to the Bankruptcy Act 1966 term. In *Whitton as Trustee of the Estate of Rose v Regis Towers Real Estate Pty Ltd (in administration)* (2007) 161 FCR 20; 5 ABC (NS) 294; [2007] FCAFC 125 at [38], Buchanan J (with whom Marshall and Tracey JJ agreed), applied *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243 as being applicable to s 5(2) and 5(3) of the Bankruptcy Act; *Eykamp v Deputy Commissioner of Taxation* (2010) 8 ABC(NS) 105; [2010] FCA 797 at [7], Buchanan J.

2.6. To that extent the application of authorities considering s 95A are relevant to s 5(2) and 5(3) of the Bankruptcy Act.

3. SOLVENCY/INSOLVENCY-LEGAL CONCEPT

3.1. Historically, the seminal consideration of the concept of insolvency was that of Barwick CJ in *Sandell v Porter* (1966) 115 CLR 666 at 670:

"*Insolvency is expressed in s 95[2] [of the Bankruptcy Act 1924 (Cth)] as an inability to pay debts as they fall due out of the debtor's own money. But the debtor's own moneys are not limited to his cash resources immediately available. They extend to moneys which he can procure by realisation by sale or by mortgage or pledge of his assets within a relatively short time – relative to the nature and amount of the debts and to the circumstances, including the nature of the business, of the debtor. The conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity. It is the debtor's inability, utilising such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates insolvency. Whether that state of his affairs has arrived is a question for the court and not one as to which expert evidence may be given in terms though no doubt experts may speak as to the likelihood of any of the debtor's assets or capacities yielding ready cash in sufficient time to meet the debts as they fall due.*"

[2] Section 95(1) relevantly provided "*Every conveyance or transfer of property, or charge thereon made, every payment made, every obligation incurred and every judicial proceeding taken or suffered, by any person* ***unable to pay his debts as they become due from his own money***.." (emphasis added)

3.2. Insolvency is **a question of fact** to be ascertained from a consideration of the person's or company's financial position taken as a whole, having regard to "commercial realities": *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213 at 223; *Re Newark Pty Ltd (in liq)* [1993] 1 Qd R 409 at 413; *Williams (as liquidator of Scholz Motor Group Pty Ltd) (in liq) v Scholz* [2008] QCA 94 at [109] per Muir JA; *Coates Hire Operations Pty Ltd v D-Link Homes Pty Ltd* [2011] NSWSC 1279 at [57] (White J); *In the matter of Ashington Bayswater Pty Ltd (In liq)* [2013] NSWSC 1008 at [4] (Black J). Insolvency should be distinguished from a temporary lack of liquidity (*Sandell v Porter* (1966) 115 CLR 666 at 670 (CLR)), with the appropriate question being whether the person or company is suffering from an endemic shortage of working capital: *Hymix Concrete Pty Ltd v Garritty* (1977) 13 ALR 321 at 328.

4. PLEADING INSOLVENCY

4.1. A pleading must be brief as the nature of the case permits and contain a statement of all the material facts on which the party relies but not the evidence by which the facts are proved.[3] The material allegations of fact are those necessary for a party to formulate a complete cause of action or ground of defence. Rule 157 of the Uniform Civil Procedure Rules relevantly requires that a party must include particulars necessary to define the issues for, and prevent surprise at, the trial and enable the opposite party to plead.

4.2. A party that pleads insolvency need not plead the facts the pleader will rely on to make out the allegation of insolvency. The material fact is that, at the relevant times, the person or company was unable to pay all of the person's or company's debts as and when they became due and payable. The facts that the pleader will rely on to make out such an allegation of insolvency is at best a matter for particulars: *Cooper v McDonald* [2009] FCA 1099 (Besanko J) at [12]; *Donnelly (Trustee) v Windoval Pty Ltd (Trustee), In the matter of Donnelly* [2012] FCA 943 at [82] (Foster J).

4.3. In *Cooper v McDonald* proceedings were brought by the liquidators under s 588FF of the Corporations Act. The defendant applied to strike out the statement of claim upon the basis that there was a failure to plead the necessary material facts for the cause of action and, therefore, it did not disclose a reasonable cause of action. One of the complaints was that there was a bare allegation that the company was insolvent at the time payments were made without the material facts to support the plea. That is, the facts the liquidators will rely on to make out the allegation of insolvency were not pleaded.

4.4. Basenko J rejected this argument saying at [12]:

[3] Uniform Civil Procedure Rules: r 149(1)(a) & (b). A pleading must also state specifically any matter, that if not stated specifically, may take the other party by surprise: r 149(1)(c). Also, where a provision of an Act is relied upon that must be specifically identified: r 149(1)(e).

> "*The material fact is that, at the relevant time or times, the company was unable to pay its debts as and when they became due and payable. It seems to me that the facts the plaintiffs will rely on to make out that allegation are, at best for the defendant, matters for particulars. The differences between material facts and particulars have been discussed in a number of cases. In the circumstances, I do no more than refer to my discussion of the differences in* Procter v Kalivis *[2009] FCA 795 at [44]–[46]*"

4.5. In the circumstances of the case no order was made for the delivery of particulars before the defence was filed. His Honour said that in due course it may be necessary for an expert's report to be delivered rather than particulars.

4.6. A like approach was taken by Foster J in *Donnelly (Trustee) v Windoval Pty Ltd (Trustee), In the matter of Donnelly* [2012] FCA 943. In the proceedings the applicant/trustee in bankruptcy alleged that a transfer of funds from the bankrupt to the transferee was void as against the trustee by reason of the operation of s 121 of the Bankruptcy Act or alternatively, s 37A of the *Conveyancing Act 1919* (NSW). The trustee claimed that the transfer was made by the bankrupt in order to put the amount thereof beyond the reach of his creditors or, alternatively, was made at a time when the bankrupt was insolvent or about to become insolvent.

4.7. Foster J at [82] said as to the allegations in the statement of claim as to insolvency as follows:

> "*Conventionally, the retrospective assessment of solvency in respect of a bankrupt generally requires the court to answer three questions: First, what were the bankrupt's debts; second, when did they fall due; and third, could the bankrupt pay those debts as and when they fell due (see* Marchesi v Apostolou *(2007) 5 ABC(NS) 131 at [95] (p 159)). But this does not mean that the party asserting that the bankrupt was insolvent as at a particular date must plead or provide by way of particulars details of the bankrupt's debts and material tending to prove that those debts were not being met as and when they became due and payable (*cf Duus v Dalvella Pty Ltd *[2007] FCA 1921). In my judgment, the material facts for present purposes are that, as at 1 July 1999, after the transactions put in place by the bankrupt on that day were effected, the bankrupt was insolvent or was about to become insolvent. The facts, matters and circumstances upon which the applicant intends to rely in order to make out the allegation of insolvency or impending insolvency are at best matters for particulars (*Cooper v McDonald *[2009] FCA 1099 at [12]). Most often, those facts will be properly characterised as matters of evidence.*"

4.8. A contrary position was taken by Lunn J in *Hall v Middleton* [2006] SASC 6. A liquidator was seeking relief against a director for alleged breaches of the Corporations Act. It was alleged that at a directors' meeting resolutions were passed that the company was insolvent, or was likely to become insolvent at some future time. The liquidator pleaded that at this time the company was solvent and but for that resolution it was not likely to become insolvent. This issue was the extent to which the material facts had to be pleaded.

4.9. The distinction between the authorities can be discerned from Lunn J's reasoning at [9] that "insolvency" as defined by s 95A of the Corporations Act ***is primarily a conclusion of law***. Whereas, the reasoning of both Besanko J and Foster J approach the question on the basis that insolvency was primarily a question of fact.

4.10. Lunn J considered that as "insolvency" is primarily a conclusion of law it is to be based on facts concerning the company's financial affairs and there needs to be a proper pleading of the facts on which the conclusion of insolvency is to be drawn in order to give fair notice to the defendant. More needs to be pleaded, His Honour said, than merely recite the definition in s 95A. It requires some pleading at the relevant times about the company's debts and their nature and about its ability to satisfy those debts. What further material facts a plaintiff need to plead will depend in part upon how they intend to prove solvency at the trial. If having been given this opportunity to do so, they do not now plead more facts to give fair notice of the case they intend to make at trial it is likely that the trial Judge will confine their evidence to the particulars which they now give.

4.11. With due respect to the reasoning of Lunn J the predominant view is that the question of solvency/insolvency is a question of fact.

4.12. The better view is that of Besanko J and Foster J, that the material allegation is the recitation of the elements of s 95A of the Corporations Act or s 5(2) or s 5(3) of the Bankruptcy Act.

5. DEBTS

WHAT IS A DEBT?

5.1. The term "debt" is defined in s 5(1) of the Bankruptcy Act to include "liability". The terms "debt" or "debts" are not defined in the Corporations Act.

5.2. Marshall J in *McBain v Palffy* [2009] FCA 260 at [16]-[26], after analysing a number of the authorities dealing with the former s 122 of the Bankruptcy Act and the meaning of the term "debt" considered in the context of the Corporations Act, concluded that contingent and prospective liabilities are relevant debts for the exercise of determining solvency. Such liabilities will not be taken into account unless there is a real likelihood of them being imposed.

5.3. An analysis of the development of the term "debts" under the bankruptcy legislation was conducted by White J in *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008) 221 FLR 164; 68 ACSR 176 at [53]-[72].

5.4. Citing *Bank of Australasia v Hall* (1907) 4 CLR 1514 at 1527 per Griffith CJ, at 1531 per Barton J, at 1536-7 per O'Connor J, and at 1547 and 1549 per Isaacs J, it was observed that that the better view is that any liability provable on the bankruptcy of a debtor constitutes a "debt" for the purposes of that section: *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008) 221 FLR 164; 68 ACSR

176 at [57], [58], [60]. It was observed by White J that nothing in the various reports surrounding the amendments to the Bankruptcy Act or Corporations Act, nor any explanatory memorandum to those Acts, have indicated that there should be any intention that the meaning of the words "debts" should change: at [56].

5.5. In *Fryer v Powell* (2001) 159 FLR 433, the Full Court of the Supreme Court of South Australia considered the meaning of the word "debt" in an insolvent trading case. Olsson J (Duggan and Williams JJ agreeing) held at [61] that the term debt should be understood in a constant sense according to its natural and ordinary English meaning. His Honour then noted that the ordinary meaning of the word is simply "a liability or obligation to pay or render something; that which one person is bound to pay to or perform for another". He also accepted with agreement a definition offered by counsel that "a debt is simply an obligation of one party to pay a sum of money to another". His Honour then noted that there was nothing in the Bankruptcy Act to suggest that any other special meaning was intended by the term "debt", and that the obligation may be present, absolute or contingent.

SIGNIFICANCE OF THE WORDS "DUE AND PAYABLE"

5.6. In *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213, Palmer J acknowledged that the use of the words "due" and "payable" in s 95A had made room for the argument that each word has a separate function such it is possible for a debt to "become due" at a different time from which it "becomes payable". His Honour rejected this proposition, holding that the distinction between these words was not relevant and that one word would have sufficed: at [32].

5.7. In *White Constructions (ACT) Pty Ltd (in liq) v White* (2004) 49 ACSR 220; [2004] NSWSC 71, McDougall J, in rejecting an argument that a debt was "due" but not "payable", supported the view of Palmer J that the words "due" and "payable" have synonymous meanings and no distinction can be drawn.

CONTINGENT DEBTS AND PROSPECTIVE DEBTS

5.8. A contingent debt exists if there is an existing obligation out of which a liability on the part of the debtor to pay a sum of money will arise in a future event, whether it be an event that must happen or only an event that may happen: *Community Development Pty Ltd v Engwirda Construction Co* (1969) 120 CLR 455 at 459; *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008) 221 FLR 164; 68 ACSR 176 at [75]. A prospective debt is one not immediately payable but which will certainly become due in the future either on some date which has already been determined, or on some date determinable by reference to future events: *Edwards v Attorney-General (NSW)* (2004) 60 NSWLR 667; 50 ACSR 122 at [59].

5.9. Marshall J in *McBain v Palffy* [2009] FCA 260 at [16], when considering s 120(3) of the Bankruptcy Act, said the weight of authority suggests that contingent and prospective liabilities are to be included as part of the person's debts provided there is a real likelihood of them being established.

5.10. In *Edwards v Attorney-General (NSW)* (2004) 60 NSWLR 667; 50 ACSR 122, the New South Wales Court of Appeal held at [60] that contingent or prospective creditors are to be taken into account in assessing solvency. The significance of a contingent liability will depend on the degree of likelihood that it will crystallise into actual or present liabilities falling due in the short-term future: *Brooks v Heritage Hotel Adelaide Pty Ltd* (1996) 20 ACSR 61 at 65.

5.11. One purpose why such debts should be taken into account is that it would be "strange" if, in determining insolvency as defined by s 95A of the Corporations Act, the court were not able to take into account contingent or prospective liabilities of a company when such liabilities are required to be taken into account when determining whether a company should be wound up on the ground of insolvency: *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008) 221 FLR 164; 68 ACSR 176 at [77].

UNLIQUIDATED DAMAGES

5.12. In the application of the terms "solvency" or "insolvency" under the Bankruptcy Act the term "debt" is defined to include "liability". That definition does not appear under the Corporations Act. In this context, care needs to be taken when considering the authorities dealing with the respective legislation. .

5.13. It has been held by the New South Wales Court of Appeal that unliquidated damages for breach of contract are not "debts" within the meaning of s 95A of the Corporations Act: *Box Valley Pty Ltd v Kidd* (2006) 24 ACLC 471. The likely liability to pay unliquidated damages, when it crystallised, was not a debt and was therefore not a liability to be taken into account under s 95A of the Corporations Act. The fact that the company had an impending liability to pay substantial damages which it would not be able to pay did not mean the company could not pay its debts as and when they became due and payable.

5.14. Bryson JA held at [14] that:

> "*The word "debt" is used in s 95A of the Corporations Act without any supporting definition. An entitlement to claim damages for breach of a contractual obligation to sell and deliver goods is not a debt within the ordinary meaning of that word.*"

5.15. At [15] it was also held:

> "*an obligation which will come into existence only upon the exercise of an election, or which when it comes into existence will be an obligation for unliquidated damages, is not a debt.*"

5.16. Gzell J, making reference to the distinction between an action for unliquidated damages and a debt, held at [73]:

> "*a claim for damages for breach of contract is not a debt for the purposes of the definition*

solvency and insolvency in the Corporations Act, s 95A".

5.17. However, in *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008) 221 FLR 164; 68 ACSR 176, White J observed that the decision of *Box Valley Pty Ltd v Kidd* (2006) 24 ACLC 471 was inconsistent with the earlier High Court decision of *Bank of Australasia v Hall* (1907) 4 CLR 1514. Under that approach, "debts" included any liability of the debtor provable on his bankruptcy, including a debtor's liability to pay unliquidated damages. While doubting the correctness of *Box Valley Pty Ltd v Kidd* (2006) 24 ACLC 471, White J at [71] considered that the court ought to follow the later decision of the Court of Appeal. Marshall J said the weight of authority suggests prospective liabilities are to be included as part of the person's debts provided there is a real likelihood of them being established: *McBain v Palffy* [2009] FCA 260 at [16].

6. TESTS

6.1. There are two approaches to assessing whether a person is solvent or insolvent: the "cash flow test" and the "balance sheet test".

6.2. The "cash flow test" is viewed as the appropriate test for assessing solvency in Australia both in respect to corporations and individuals: *Bank of Australasia v Hall* (1907) 4 CLR 1514 at 1512; *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1; [2008] WASC 239 at [1072], varied in part on appeal: *Westpac Banking Corporation v The Bell Group Ltd (In liq) (No 3)* (2012) 270 FLR 1, [2012] WASC 157, leave to appeal to High Court granted; *Coates Hire Operations Pty Ltd v D-Link Homes Pty Ltd* [2011] NSWSC 1279 at [47].

6.3. The cash flow test is an assessment of an ability to meet the debts when they fall due. This looks to the overall health of a person or company. The balance sheet test focuses on the value of the assets over liabilities, which may include assets which are not readily realisable.

CASHFLOW TEST

6.4. Section 95A of the Corporations Act and s 5(2) and 5(3) of the Bankruptcy Act enshrine the cash flow test of insolvency which focuses on liquidity and the viability of the business: *Crema Pty Ltd v Land Mark Property Developments Ltd* (2006) 58 ACSR 631 at 652; *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1; [2008] WASC 239 at [1072]; *Moskios v Bishay* [2013] FCCA at [33] (Judge Altobelli). This has been confirmed by the Court of Appeal: *Keith Smith East West Transport Pty Ltd (in liq) v Australian Taxation Office* (2002) 42 ACSR 501; [2002] NSWCA 264 at [33].

6.5. Under the cash flow test, the court will effectively examine whether an individual or company can actually pay its creditors, as distinct from a rigid examination of the company records. In *Bank of Australasia v Hall* (1907)

4 CLR 1514, Isaacs J held at 1521 that "the debtor's position depends on whether he can pay his debts, not on whether a balance sheet will show a surplus of assets over liabilities".

6.6. In *Re Tweeds Garages Ltd* [1962] Ch 406, Plowman J, quoting from Buckley on the Companies Acts (13th ed, 1957), held that:

> *"it is useless to say that if its assets are realised there will be ample to pay 20 shillings in the pound: this is not the test. A company may be at the same time insolvent and wealthy. It may have wealth locked up in investments not presently realisable; but although this be so, yet if it have not assets available to meet its current liabilities it is commercially insolvent and may be wound up.*"

6.7. The cash flow test also calls for a consideration of the ability to convert assets into cash in a relatively short period of time, at least to the extent of meeting its debts as and when they fall due: *Re Tweeds Garages Ltd* [1962] Ch 406 at 410; *Rees v Bank of New South Wales* (1964) 111 CLR 210; *Melbase Corporation Pty Ltd v Segenhoe Ltd* (1995) 17 ACSR 187 at 198. However, raising funds by sale or mortgage of income producing assets might provide the person or company with sufficient funds to meet the current liabilities, but deprive the person or company of the ability to meet liabilities due in the foreseeable future, and therefore could lead to a conclusion of insolvency: *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1; [2008] WASC 239 at [1091]. Therefore, the court must be satisfied that there are reasonable grounds for predicting that a person or company presently solvent will remain so: *Re United Medical Protection Ltd* (2003) 47 ACSR 705 at [57]; *Moskios v Bishay* [2013] FCCA at [33] (Judge Altobelli).

6.8. One reason the cash flow test is used is that the words "as and when they become due and payable" requires looking into the future beyond the particular day on which the question of solvency or insolvency is to be determined: *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant* (2008) 221 FLR 164; 68 ACSR 176 at [44]; *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608 at [103]. The cash flow test is closely related to the concept of commercial realities.

6.9. As Jackson J said: "In general, it is no answer for a company which is unable to meet its current liabilities to say that its assets exceed the liabilities overall. The time aspect of the test of solvency - 'as they become due and payable' - will not be satisfied": *Re Cube Footwear Pty Ltd* (2012) 10 ABC(NS) 423; [2012] QSC 398 at [1].

BALANCE SHEET TEST

6.10. Referring to s 95A of the Corporations Act, Lander J in the Federal Court held in *Cooper v Commissioner of Taxation* (Cth) (2004) 139 FCR 205 at [61]:

> "*The definition suggests that the issue of solvency needs to be resolved by having regard to the cash flow of a company but, of course, the sum total of its assets and liabilities, as disclosed in*

> *the balance sheet, is not irrelevant.*"

6.11. Under the balance sheet test the court will examine whether the value of the total liabilities of an individual or company exceeds the value of the total assets: *Bank of Australasia v Hall* (1907) 4 CLR 1514 at [1521].

6.12. Such approach has been criticised as it fails to consider assets that cannot readily be exchanged for money: *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1; [2008] WASC 239 at [1068]. It is possible that an individual or company might be cash flow insolvent but show a positive balance sheet where assets exceed liabilities: *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* at [1070]. In *McLellan, in the matter of The Stake Man Pty Ltd v Carroll* (2009) 76 ACSR 67; [2009] FCA 1415 at [139], in considering the values in the balance sheets in respect of research and development and goodwill, Goldberg J noted that they had no realisable value to assist in the company's cash flow situation.

6.13. There is other authority to support the proposition that the balance sheet test does have some relevance in assessing insolvency: *Sandell v Porter* (1966) 115 CLR 666 at 671 (CLR); *Ace Contractors & Staff v Westgarth Development Pty Ltd* [1999] FCA 728 at [44]; *Australian Securities and Investments Commission v Edwards* (2005) 220 ALR 148; 54 ACSR 583; [2005] NSWSC 831 at [96]; *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1; [2008] WASC 239 at [1065]-[1075].

6.14. Notwithstanding the defects in the balance sheet test, Bryan J in *Heide Pty Ltd v Lester* (1990) 3 ACSR 159 held at 165 that in assessing solvency, regard should be had to the resources available, which includes cash and credit:

> "*In determining whether the company would be able to pay the debt as and when it became due all the cash resources available to the company, including credit resources, are to be looked at and in determining those credit resources there are to be taken into account the times extended to the company to pay its creditors, on the one hand, and the times within which it will receive payment of debts owing to it on the other hand.*"

6.15. The balance sheet test is also useful indicia of insolvency. For example, solvency might be inferred by a preponderance of current assets over current liabilities: *Switz Pty Ltd v Glowbind Pty Ltd* (2000) 18 ACLC 343; [2000] NSWSC 222 at [37]. However, it has been stated that, only as a "rule of thumb", will a person or company be regarded as insolvent if its current liabilities exceed its current assets: *Quick v Stoland Pty Ltd* (1998) 87 FCR 371; 157 ALR 615; 29 ACSR 130 at 380 (FCR). Put in another way, an inability to pay debts at a particular time is an indication of insolvency, but this is also consistent with the possibility of a temporary lack of liquidity: *Austin Australia Pty Ltd v De Martin Gasparini Pty Ltd* [2007] NSWSC 1238 at [8].

7. COMMERCIAL REALITY

7.1. Insolvency is a question of fact to be ascertained from a consideration of the person's or a company's financial position as a whole. It is well established that in considering the financial position, reference may be had to "commercial realities" rather than the strict legal rights of the parties: *Williams (as liquidator of Scholz Motor Group Pty Ltd) (in liq) v Scholz* [2008] QCA 94 at [108]. That includes the "practical business environment": *Coates Hire Operations Pty Ltd v D-Link Homes Pty* Ltd [2011] NSWSC 1279 at [69].

7.2. Commercial realities will be relevant in considering what resources are available to meet liabilities as they fall due, whether resources other than cash are realisable by sale or borrowing upon security, and when such realisations are achievable: *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608 at [106]; upheld on appeal in *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243 at [79].

STRICT LEGAL RIGHTS

7.3. In assessing the question as to whether a debt is due and payable, Palmer J in *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213 enunciated, amongst others, these propositions:

1. The commercial reality that creditors will normally allow some latitude in time for payment of their debts does not, in itself, warrant a conclusion that the debts are not payable at the times contractually stipulated and has become debts payable only upon demand.
2. In assessing solvency, the court acts upon the basis that a contract debt is payable at the time stipulated for payment in the contract unless there is evidence, proving to the court's satisfaction, that:
    i. there has been an express or implied agreement between the company and the creditor for an extension of the time stipulated for payment; or
    ii. there is a course of conduct between the company and the creditor sufficient to give rise to an estoppel preventing the creditor from relying upon the stipulated time for payment; or
    iii. there has been a well-established and recognised course of conduct in the industry in which the company operates, or as between the company and its creditors as a body, whereby debts are payable at a time other than that stipulated in the creditors' terms of trade or are payable only on demand.
3. It is for the party asserting that a company's contract debts are not payable at the times contractually stipulated to make good that assertion by satisfactory evidence.

7.4. Earlier, Young J in *Hamilton v BHP Steel (JLA) Pty Ltd* (1995) 13 ACLC 1548 at 1552 indicated that, in looking at the commercial reality, the court should take into account prevailing business practices. A course of conduct may mean that despite the due day for payment, industry practice or dealings between the parties demonstrate that creditors accept that debtors will often not pay creditors within normal trading terms. In business circumstances, sometimes it is quite necessary in an industry which is experiencing recession; otherwise creditors may not be able to sell their product at all. Even though creditors would prefer debtors to pay within the trading terms, it is better to have recalcitrant debtors than sell no product at all: see *Manpac Industries Pty Ltd v Ceccattini* (2002) 20 ACLC 1304; [2002] NSWSC 330 at [40] where Young CJ in Eq reflected on his earlier statements in *Hamilton v BHP Steel (JLA) Pty Ltd.*

7.5. In *Manpac Industries Pty Ltd v Ceccattini* (2002) 20 ACLC 1304; [2002] NSWSC 330 at [40], Young CJ commented that what he had said in *Hamilton v BHP Steel (JLA) Pty Ltd* had been developed into a much stronger statement in *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213, and the propositions in *Hamilton v BHP Steel (JLA) Pty Ltd* are good commercial and legal common sense.

7.6. In *Emanuel Management Pty Ltd (in liq) v Foster's Brewing Group Ltd* (2003) 178 FLR 1 Chesterman J (as he then was) held that the due date for payment is fixed by contract, and any bare assertion by a creditor that it would accept payments later than the date stipulated in the contract does not have the effect of extending the time for payment. His Honour held that a course or dealings cannot postpone the due date for payment unless there is a representation from the creditor in the form of a promissory estoppel for an extension of payment or a binding variation to the agreement. The question is not whether debts were paid on time but whether they could have been paid. His Honour said that persistent late payment of debts often gives rise to the inference of insolvency, but the inference may be rebutted if there is evidence that shows a reason for late payment other than incapacity to pay.

7.7. The approach in *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* has been doubted. In *Iso Lilodw' Aliphumeleli Pty Ltd (in liq) v Commissioner of Taxation* (2002) 42 ACSR 561; [2002] NSWSC 644, Davies AJ, accepting that insolvency should be determined as a matter of commercial reality, held at [14] that the approach in *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* might imply a "legality or inflexibility which is inconsistent with the point that the ultimate issue is a question of fact". However, McDougall J in White Constructions (ACT) *Pty Ltd (in liq) v White* (2004) 49 ACSR 220; [2004] NSWSC 71 at [291]-[292], responded to this criticism by endorsing the propositions enunciated by Palmer J in *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation*, commenting that:

> 1. For my part, I do not think that Palmer J, in the fourth, fifth and sixth propositions that he stated, was seeking to lay down exhaustively the circumstances in which indulgences that creditors may allow will be taken into account, or the manner in which such indulgences will be taken into

account. It is certainly possible to read the fifth proposition as being expressed in prescriptive terms; but even there, I think, his Honour was stating, in effect, the basis upon which the courts have generally assessed the significance of indulgences that were shown to have been granted.

2. If, contrary to my understanding, his Honour were intending, in the fourth, fifth and sixth propositions, to state exhaustively the circumstances in which indulgences will be considered relevant, and the weight that will be attributed to them, then I would share the reservations expressed by Davies AJ. But I do not so read what Palmer J said.

7.8. The propositions from *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* have also received endorsement in *Wily v Terra Cresta Business Solutions Pty Ltd* [2006] NSWSC 1042 at [40], where the court held that the "best statement of what is the test for insolvency" was laid down by Palmer J in *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation*. The court cautioned at [40] that:

> "*one must not go overboard and one must not assume that creditors who are not pressing for payment will be in that happy state forever, and one must look to see whether there is evidence that there has been express or implied agreement between the company and its creditors as to when the creditor will expect the debt to be paid.*"

7.9. The Court of Appeal in *Keith Smith East West Transport Pty Ltd (in liq) v Australian Taxation Office* (2002) 42 ACSR 501; [2002] NSWCA 264 at [33], cited S*outhern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* with apparent approval, holding that in assessing solvency, the court will pay regard to an express or implied agreement between a company and its creditor for an extension of the time stipulated for payment.

7.10. Katzmann J in *Dunlop v Fishburn (No 3)* [2012] FCA 315 at [31] when considering insolvency under the Bankruptcy Act said that as the test for solvency is the cash flow test the court may have regard to any express or implied agreement between the debtor and creditor for extension of time stipulated for payment.

7.11. There is, however, authority for the proposition that it is not a commercial reality to treat a debt which is statutorily imposed as though it is not presently due, notwithstanding any delay in its being enforced or the possibility of a review process: *Hall v Poolman* (2007) 215 FLR 243; [2007] NSWSC 1330. In that case, Palmer J stated, in response to an argument that a taxation debt to the Commissioner of Taxation was not due for payment as a matter of "commercial reality" because of the possibility the debtor company could have a statutory demand set aside or that any judgment could be stayed until a review process had been completed, held at [91]:

> "*the tax legislation clearly and unequivocally made that debt payable. If the legislature clearly says that a tax debt is payable at a certain time, neither the court nor a company director can disregard that statutory imperative by an appeal to commercial*

reality. Absent an agreement by the Commissioner to defer payment, it is not commercial reality to treat a present liability, statutorily imposed, as if it does not exist."

7.12. The court may take into account as part of the commercial reality the prospect of compromise with the creditors, which would have the result that debts as compromised could be paid as and when they fall due. Although, the exercise in prediction involves uncertainty and speculation it is a question to be answered on the balance of probabilities. That is, in determining at a relevant date whether or not a person or company is insolvent, the possibility of an alteration to the amount of a debt or the due date for its payment is relevant to that question. A mere theoretical possibility of such a compromise would not preclude the finding of insolvency. However, the circumstances at the relevant date might be such that to overlook an imminent compromise would be to ignore the commercial reality of the position of the person or company: *Public Trustee (Qld) v Octaviar Ltd* (2009) 73 ACSR 139; [2009] QSC 202 at [133].

PROVING CONCESSIONS BY CREDITORS TO SUPPORT SOLVENCY

7.13. In *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213, Palmer J held, in the absence of an express or implied agreement for an extension of time, conduct giving rise to an estoppel, or a well-established and recognised course of conduct within the industry or company with its creditors, debts will be considered payable in accordance with the terms of the agreement or contract. Palmer J also pointed out that the significance of indulgences given by creditors will vary depending upon whether the case is one relating to "actual insolvency" (prospective insolvency) or "reasonable grounds to expect insolvency" (or retrospective insolvency).

7.14. In *Keith Smith East West Transport Pty Ltd (in liq) v Australian Taxation Office* (2002) 42 ACSR 501; [2002] NSWCA 264, the New South Wales Court of Appeal considered an arrangement between the Australian Tax Office and the debtor company. Mason P (with whom Handley and Giles JJA agreed) held that the company's arrangement for a gradual reduction in debt had been substantially adhered to during the relevant period and as such insolvency could not be established. Insolvency was being assessed retrospectively in that case, and the court accepted that the evidence demonstrated that the Australian Taxation Office was willing to "hold its hand" before and during the relevant period.

7.15. In *White Constructions (ACT) Pty Ltd (in liq) v White* (2004) 49 ACSR 220; [2004] NSWSC 71, McDougall J considered an informal arrangement between the debtor company and a creditor. This case was one of "actual" or "prospective" insolvency and related to an undocumented arrangement whereby intercompany debt would not be called upon until the debtor group company was in a position to pay. Each director gave evidence to this effect, but there was no evidence of a formal adoption of this policy in writing. There was evidence from a financial statement from an earlier financial year which noted in the "summary of significant accounting policies" that "the accounts are prepared on a going concern basis which assumes that a related party will not call for repayment of monies owing to it until, [sic] sufficient funds are available". This was repeated in the financial statement the following year. Further, there were

notes prepared by auditors, as well as a handwritten notation from an employee of the group, which confirmed the arrangement. McDougall J accepted the existence of the policy (at [270]) for these reasons:

1. [First], I accept the evidence of the director defendants as to their understanding or belief; and I accept that the understanding or belief was rationally based. That is to say, I accept that their understanding or belief reflects the factual reality.

2. [Second,] more importantly, the existence of such a policy seems to me to accord with commercial common sense, having regard to the way in which (in particular) WCL carried on its operations, through operating subsidiaries in each State or Territory.

3. [Third], the existence of that policy is confirmed by the evidence that I have referred to in [263]-[268] above.

7.16. McDougall J noted at [296] that under ordinary principles, the debt should, in the absence of evidence to the contrary, be regarded as payable on demand. However, at [298], his Honour held:

> "*The manner in which the debts came into existence may be clear enough in outline, but there is no detailed evidence showing how the balances moved from time to time. Nor is there evidence of the precise transactions in respect of which the debts arose. However, I conclude that the debts arose on a basis understood by all concerned: that a demand for payment would not be made unless the debtor could afford to pay the debt. On that basis, I think it is not correct to classify the debts as being payable on demand. Where a debt is payable on demand, it is taken to be payable forthwith because the creditor has an uncontrolled discretion to make demand at any time. However, the effect of the arrangement that I have found proved was to fetter the discretion of the creditor to demand repayment. The creditor could not demand repayment unless the debtor was able to meet the demand. In those circumstances, the better analysis is that the debt was due not on demand but upon a contingency: the contingency being, of course, the ability of the debtor to meet any demand.*"

7.17. The ultimate effect of this finding was that solvency was only to be assessed by reference to an ability to pay debts to creditors other than the group creditors.

7.18. It should be understood that the principle applicable in most cases is that when the due date for payment is fixed by creditors, a bare assertion by a creditor that it would accept late payment does not have the effect of extending the time for payment: *Emanuel Management Pty Ltd (in liq) v Foster's Brewing Group Ltd* (2003) 178 FLR 1.

DIRECTORS OR RELATED PARTIES NOT REQUIRING PAYMENT OF DEBT

7.19. There are many instances where a court has taken into account in assessing insolvency the commercial reality that a director or a related party does not require payment of the debt and will not seek payment of the debt: *Coates Hire Operations Pty Ltd v D-Link Homes Pty Ltd* [2011] NSWSC 1279 at [77]-[80] and at [68]-[72] where White J refers to *Brooks v Heritage Hotel Adelaide Pty Ltd* (1996) 20 ACSR 61 at 54-65;

Totterdell v Nicol-Bermeister (1995) 13 ACLC 1521 at 1526; *Re Kerisbeck Pty Ltd* (1992) 10 ACLC 619 at 621.

7.20. In *Australian Beverage Distributors v The Redrock Co* (2008) 26 ACLC 74, Austin J considered the evidence of a number of directors and related parties to the effect that loans given in favour of the company would not be repayable within 12 months, and thereafter would be payable on demand. Each provided a letter to the directors confirming that arrangement. Further, two directors gave evidence as to the existence of loan facility funds which would be used to fund any shortfall in the operating profit of the company. The court held that the evidence amounted to a "cogent demonstration" of the willingness of the directors and related parties to advance the funds, when "one has regard not only to what the directors and related parties have said but also to what they have done by way of provision of funds". Austin J also held at [156] that:

> "*The loans by directors and related parties are for a very large total amount but there is evidence, not identical with respect to each loan though substantially along the same lines, sufficient to persuade the court that the loans are not debts immediately due and payable or due and payable in the near future. The lenders have agreed that no demand for repayment will be made until May 2008 at the earliest, and it appears there is no present intention to make demand for payment at that time.*"

7.21. In *Re Cube Footwear Pty Ltd* (2012) 10 ABC(NS) 423; [2012] QSC 398 the support of a related party company was not only recorded in a deed but was objectively determined from the surrounding circumstances. The directors and shareholders of the related entity were part of the extended family of the director and shareholders of the company and there was evidence that the support had been provided over a number of years. There was no reason to consider that such support would not continue.

7.22. If that fact is to be taken into account by the court there will need to be evidence by the director or related party regarding an intention not to require payment of the debt. Be mindful that views of judges may not be the same as cogency of the evidence they require to establish this support. The preferable position, therefore, is that this be documented in the form of a deed or agreement if there is to be consideration flowing from the debtor to the creditor, such as payment of interest.

8. ACCESS TO FUNDS FROM THIRD PARTIES

THE SIGNIFICANCE OF THE STATUTORY DEFINITION OF INSOLVENCY

8.1. There has been much case law considering the effect of the omission of the words "from [its] own money" from the previously applied s 122 of the Bankruptcy Act. Earlier authorities indicated that a company is not solvent merely because it was able to borrow monies on an unsecured basis: *Kyra Nominees Pty Ltd (in liq) v National Australia Bank Ltd* (1986) 4 ACLC 400; *Taylor v ANZ Banking Group Ltd* (1988) 13 ACLR 780; 6 ACLC 808 at 812 (ACLC).

8.2. However, in *Re RHD Power Services Pty Ltd (in liq)* (1990) 3 ACSR 261; 9 ACLC 27, McPherson SPJ, making reference to s 122, disagreed with the strictness of the earlier approach, holding that in some circumstances a company's ability to obtain unsecured credit may in fact be compelling evidence that the company is solvent. In any case, McPherson SPJ followed the earlier approach because the company in question was only able to pay its debts because of the continuing support of its parent company.

8.3. In *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608, Palmer J reviewed the authorities and noted that the element that the debtor pay debts out of the debtors own money no longer appeared in the definitions of solvency in s 5(2) and 5(3) of the Bankruptcy Act nor in s 95A of the Corporations Act. This notwithstanding, Palmer J at [100] observed that some cases had continued to follow the common law approach from *Sandell v Porter* (1966) 115 CLR 666 whereby there was a requirement that the debtor satisfy creditors out of his or her own money. Palmer J noted that the decisions cited at [100] had implicitly assumed that s 95A had not changed the pre-existing law.

8.4. Palmer J held that the new definition of insolvency had changed the pre-existing common law approach such that it was no longer necessary to ascertain whether the company could pay its debts "from its own monies" to establish solvency. On appeal, Giles JA (with whom Hodgson and McColl JJA agreed) held at [109] that:

> "*Particularly when the limiting words are no longer part of the test, there is no compelling reason to exclude from consideration funds which can be gained from borrowings secured on assets of third parties, or even unsecured borrowings. If the company can borrow without security, it will have funds to pay its debts as they fall due and will be solvent, provided of course that the borrowing is on deferred payment terms or otherwise such that the lender itself is not a creditor whose debt cannot be repaid as and when it becomes due and payable. It comes down to a question of fact, in which the key concept is ability to pay the company's debts as and when they become due and payable.*"

8.5. However, Giles JA noted that even before the new definition of "insolvency" was inserted into s 95A of the Corporations Act and s 5(2) and 5(3) of the Bankruptcy Act, there were cases that held a company's capacity for unsecured borrowings could be taken into account in assessing solvency: *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243 at [109] citing *Re RHD Power Services Pty Ltd (in liq)* (1990) 3 ACSR 261; 9 ACLC 27; *Re Adnot Pty Ltd* (1982) 7 ACLR 212; 1 ACLC 307; *Re a Company* (1986) BCLC 261.

8.6. There is now some debate about whether the omission of the requirement that payment be from the debtor's own money represents a change in the pre-existing law: *Crema Pty Ltd v Land Mark Property Developments Ltd* (2006) 58 ACSR 631 at [143]; *Australian Securities and Investments Commission v Sydney Investment House Equities Pty Ltd* [2008] NSWSC 1224 at [55]; *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243 at [110]. In any case, whether or not there was a change in the law, the present law is clear. Ultimately, if the court is satisfied, as a matter of commercial

reality, that the company has a resource available to pay its debts as they become payable, then that resource can be taken into account. It matters not that the debt is an unsecured borrowing or voluntary extension of credit by another party: *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608 at [116], upheld on appeal in *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243 at [109]; *Re Cube Footwear Pty Ltd* (2012) 10 ABC(NS) 423; [2012] QSC 398 at [17], [18] (Jackson J). The Full Court of the Federal Court followed the approach of Palmer J in *Whitton as Trustee of the Estate of Rose v Regis Towers Real Estate Pty Ltd (in administration)* (2007) 161 FCR 20; 5 ABC (NS) 294; [2007] FCAFC 125 at [35]-[38]. Further, Palmer J's analysis was also approved by Owen J in *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1; [2008] WASC 239 at [1065]-[1075].

WHICH THIRD-PARTY FUNDS ARE RELEVANT?

8.7. There is no doubt that funds which, on a realistic commercial assessment, are capable of being raised from outside sources are relevant in assessing solvency: *Australian Securities and Investments Commission v Edwards* (2005) 220 ALR 148; 54 ACSR 583; [2005] NSWSC 831 at [99]. However, an unsecured borrowing from a related entity or director will not enhance (or have the potential to avoid a finding of solvency) if the effect of its terms is that the loan is a debt which is immediately due or near due: *Leveraged Equities Ltd v Hilldale Australia Pty Ltd* (2008) 26 ACLC 182; [2008] NSWSC 190 at [57]. In such a case, a loan which substitutes one form of immediate or near immediate obligation for another will not assist the debtor: *Australian Securities and Investments Commission v Edwards* at [99]. The capacity to raise funds from external sources must be judged in a practical and business-like way by reference to commercial realities, not by some theoretical textbook exercise. Possibilities are not enough. Genuine and realistic availability, as a matter of commercial reality, must be seen: *Australian Securities and Investments Commission v Edwards* at [99]. For example, in *Australian Securities and Investments Commission v Edwards*, a short-term loan on onerous terms was held as merely substituting debt carrying a one-month term for debt that was overdue. This did nothing to enhance the company's solvency.

8.8. In *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243, the Court of Appeal acknowledged at [110] and [116] the possibility of intra-group company borrowing as relevant to the question of solvency. In *Hall v Poolman* (2007) 215 FLR 243; [2007] NSWSC 1330, Palmer J at [64], citing *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608, held that if one member of a group of companies has, as a matter of commercial reality, ready recourse to the assets of another member of the group for payment of the first company's debts as they fall due, and that recourse will not result in the insolvency of the second company or in merely delaying the insolvency of the first, then the court may have regard to that fact in assessing whether the first company is able to pay its debts as they fall due.

8.9. There is some authority for the proposition that unsecured loans by directors cannot be taken into account as enhancing the solvency of a company: *Re Mike Electric (Aust) Pty Ltd (in liq)* (1983) 1 ACLC 758; *Re RHD Power Services Pty Ltd (in liq)* (1990) 3 ACSR 261; 9 ACLC 27. However, it has been stated by the Court of Appeal that there should be no objection in principle to regarding financial support by directors as relevant where the evidence establishes that the directors are likely to continue it. The most important consideration is the commitment and degree to which it is likely that the support will continue: *Williams (as liquidator of Scholz Motor Group Pty Ltd) (in liq) v Scholz* [2008] QCA 94 at [110].

8.10. In *Chan v First Strategic Development Corp Ltd* [2015] QCA 28 at [41] to [44] Morrison JA specifically considered this issue. His Honour referred to his decision in *Interational Cat Manufacturing Pty Ltd v Rodrick* (2013) 97 ASCR 200; [2013] QCA 372 at [105] (with whom Holmes and Gotterson JJA agreed) that "regard can be had to financial support where the evidence establishes that the directors are likely to continue it" and to a statement of Muir JA in *Williams (as liquidator of Scholz Motor Group Pty Ltd (in liq)) v Scholz* [2008] QCA 94 that "the most important consideration is the degree of commitment to the continuation of financial support". His Honour, also, agreed with the observation of Palmer J in *Lewis v Doran* "that the prospects of obtaining necessary funds from a party, which is not obliged to provide them, must be such as to give the company something more than a chance of paying its debts; the prospects must be sufficient to make the company able to do so…there must be a sufficient degree of likelihood for the company, and those directing it, to be able to rely upon the availability of those funds when incurring the relevant debts."

PROVING SUPPORT BY DIRECTORS AND THIRD PARTIES

8.11. The starting point as to the nature of evidence required in order for the court to accept a submission that the solvency of a person or company is enhanced by reason of support from directors or third parties (such as a capital injection or unsecured loan) comes from the statement of Palmer J in *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608. His Honour held (at [113]) that the willingness of a third party to advance unsecured funds on a deferred repayment arrangement should be "cogently demonstrated, if not as a matter of legal obligation, then as a matter of commercial reality". This statement has been quoted with approval in subsequent decisions: *Lewis v VI SA Australia Pty Ltd* (2008) 68 ACSR 493; [2008] FCA 1801 at [21]; *Australian Beverage Distributors v The Redrock Co* (2008) 26 ACLC 74 at [156]; *Australian Securities and Investments Commission v Edwards* (2005) 220 ALR 148; 54 ACSR 583; [2005] NSWSC 831 at [98]. Another consideration is that the court will generally be sceptical of a third party's mere assertion to provide support: *Lewis v VI SA Australia Pty Ltd* (2008) 68 ACSR 493; [2008] FCA 1801 at [21].

8.12. Where the financial support is from a source which cannot be compelled by legal arrangement, there must be a degree of assuredness that the financial support will be forthcoming and at such a level that a court could conclude that the person/company was able to pay his or her debts or its debts as and when the fall

due, rather than mere possibility of doing so. The financial support does not have to be absolutely certain to be sufficient and equally it does not have to be absolutely uncertain in order to be insufficient. Although, the determination of this issue will depend on the particular factual circumstances of each case, where the financial support is being provided by a related party (such as a director or related entity, for a company) and in circumstances where is there is no formalised agreement or understanding, it is necessary that cogent evidence be provided which will enable the court to conclude that there is such a degree of commitment on the part of the provider of the financial support to continue, such that it can be said at any point in time it was likely to be continued, with the result that, at those time the person/company was able to pay his or her debts or its debts as and when they fell due: *Chan v First Strategic Development Corp Ltd* [2015] QCA 28 at [43], [44].

8.13. Is a promise sufficient? Hammerschlag J in *Leveraged Equities Ltd v Hilldale Australia Pty Ltd* (2008) 26 ACLC 182; [2008] NSWSC 190, was more sceptical of affidavit evidence provided by a director as to his preparedness to advance moneys to assist the debtor company pay its debts as and when they fell due. The director identified details of a loan facility available to him, and his preparedness to use such funds to lend to the company if it became necessary to assist the company. The court held that as a matter of commercial reality, the funds could not be considered as being available to the company to assist its solvency due to the non-binding nature of the statements and the fact that the director only lent those funds to rebut the presumption of insolvency, not to enable it to pay its debt.

8.14. In *Leveraged Equities Ltd v Hilldale Australia Pty Ltd*, Hammerschlag J treated sworn affidavit evidence as to the existence of a binding loan by a director to the debtor company more favourably. The director had entered into a Deed of Loan under which he agreed to advance substantial funds to the company for three years from the date of the Deed, providing for an interest of 8% per annum compounding six monthly but payable only upon the expiry of the term of the loan. There was evidence of the deposit of such funds into the bank account of the company. In finding that the funds represented a resource available to the company to pay its debts, the court (at [70]-[72]) took into account the fact that the agreement was a binding arrangement, and that there was no basis to conclude that the company's directors would breach their duties by rescinding the loan or effecting early repayment to the company's detriment.

9. THE FUTURE

9.1. There is no statutory defined future period or time in which the assessment of solvency is to be made.

9.2. In *Bank of Australasia v Hall* (1907) 4 CLR 1514, the High Court held at 1527 that the phrase debts "as they become due" was a phrase which "looks to the future". Griffiths CJ held that a consideration of solvency should be of the "reasonably immediate future"; applied *McBain v Palffy* [2009] FCA 260 at [15]; *Coates Hire Operations Pty Ltd v D-Link Homes Pty Ltd* [2011] NSWSC 1279 at [68].

9.3. Consistent with this approach, Austin J in *Re United Medical Protection Ltd* (2003) 47 ACSR 705 held that assessing solvency "calls for a degree of forward analysis". In that case, Austin J held at [57] that he would make a termination order of the appointment of a provisional liquidator if there was an identified future reduction or absorption of cash flow, notwithstanding a present ability to pay debts. He further held that:

> "*I would not in the exercise of my discretion make an order for termination of the appointment of the provisional liquidator, because of the damage that would be done to creditors at that future time. It is therefore necessary for me to be satisfied not only that the companies are presently solvent, but that there are reasonable grounds for predicting that they will remain so*."

9.4. In *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243, Giles JA, in considering the question of the assessment of the future solvency of the company, held (at [103]):

> "*how far into the future will depend on the circumstances including the nature of the company's business and, if it is known, of the future liabilities.*"

9.5. For example, it has been held that an insurer who is forced to use premium income from newly written policies to meet its existing liabilities, leaving it without resources to meet future claims on those policies, is insolvent as a matter of "commercial reality and common sense" even if there would be a considerable lapse of time before those claims arise: *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008) 221 FLR 164; 68 ACSR 176 at [45].

9.6. Bryson JA in *Box Valley Pty Ltd v Kidd* (2006) 24 ACLC 471 said at [56] that the use of "is" able to pay debts refers to a capacity and not a fixed state of time. This is reflected by the use of the terms "able to pay" and "as and when". Accordingly, this does not affect the principle that a temporary lack of liquidity does not constitute insolvency.

9.7. A person or company that is presently insolvent (as opposed to temporary liquidity problems) cannot contend that it will become solvent in the future to prevent a finding of solvency. In *Fryer v Powell* (2001) 159 FLR 433, the Full Court of the Supreme Court of South Australia held that in assessing insolvency, it is not appropriate to base that assessment on the prospect that the company might be able to trade profitably in the future and thereby restore its financial position. The question is whether, at the relevant time, it is able to pay its debts as they become due, and not whether it might be able to do so in the future if given time to trade profitably.

9.8. The further a court looks into the future, the more speculative is the determination of the events that might occur. A court ought to avoid speculation. The reliability of any prediction of future cash flows will be dependent upon the reasonableness of the assumptions that form the basis of the forecast. The confidence of the forecaster's predictions will decrease as the period increases: *Re Cube Footwear Pty Ltd* (2012) 10 ABC(NS) 423; [2012] QSC 398 at [53] (Jackson J).

10. PROSPECTIVE AND RETROSPECTIVE INSOLVENCY

10.1. In cases where insolvency is in issue, insolvency can be assessed as at the time of the hearing (prospectively) or at an earlier date (retrospectively).

PROSPECTIVE INSOLVENCY

10.2. Prospective insolvency arises where the court is considering the hearing of a creditor's petition and the debtor contends that he or she is able to pay his or her debts under s 52(2)(a) of the Bankruptcy Act. Alternatively, where a company is sought to be wound up in insolvency, the court must determine whether the company is able to pay its debts as and when they fall due and payable, including debts in the near future. In *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608, Palmer J held at [109]-[110]:

> "*Where the question is prospective insolvency, however, the court's task is more difficult simply because foresight, rather than hindsight, is called into play. One can appreciate the court's reluctance to conclude that a company will be able to pay those debts which must be taken into account as a matter of commercial reality as at the relevant date only because it claims to have access to funds which a third party is said to be willing to lend without security.*"

10.3. In such a case there is a considerable measure of trust, if not speculation, that "things will turn out all right in the end". If the third party is free to change its mind after the winding up application is dismissed, the company's creditors are left with their hopes disappointed and their debts unpaid.

10.4. Palmer J held at [113] that in such a case, a court would be sceptical of an assertion that a party is willing to advance funds unsecured on such terms as would not bring about insolvency. The willingness of any third party advancing funds would need to be cogently demonstrated, if not as a matter of legal obligation, then as a matter of commercial reality.

PROSPECTIVE INSOLVENCY-WHERE PRESUMPTION OF INSOLVENCY

10.5. Section 459C prescribes a number of circumstances in which it is presumed that a company is insolvent. A company is presumed to be insolvent if it has failed to comply with a statutory notice of demand.

10.6. To oppose a winding up application on the ground on which a company could have relied in an application to set aside the demand, namely, that there is a genuine dispute about the debt requires leave of the court: s 459S. To take that course it would be necessary to establish on the application for leave that the dispute as to the debt will affect the determination as to the solvency of the company. If the position of the company is that it is solvent whether or not the debt claimed is owing then the company could not seek leave under s 459S.

10.7. A number of authorities have identified that in order to rebut the presumption of insolvency the company needs to adduce the "*fullest and best*" evidence of its financial position: *Expile Pty Ltd v Jabbs*

Excavations Pty Ltd [2003] NSWCA 163; (2003) 45 ACSR 711 citing a passage from the judgment of Weinberg J in *Ace Contractors & Staff Pty Ltd v Westgarth Pty Ltd* [1999] FCA 728.

10.8. The "*fullest and best*" requires verification of the company's assets (including values) and liabilities.

10.9. For example, verification of trade debtors or work in progress must be take into consideration whether the debts or work in progress are recoverable, when the debts are expected to be paid and when the work in progress will be invoiced. An ageing analysis ought to be prepared for both debtors and trade creditors. Evidence of the terms of trade for both debtors and creditors ought to be adduced. If debtors or creditors are beyond the trading terms then that needs to be explained in the evidence.

RETROSPECTIVE INSOLVENCY

10.10. Retrospective insolvency arises when insolvency is being determined at an earlier date, for example, the recovery of a preference under s 122: *McBain v Palffy* [2009] FCA 260 at [14].

10.11. In *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608, Palmer J at trial held that when the solvency is to be determined retrospectively, the court has the inestimable benefit of the wisdom of hindsight (at [108]):

> "*One can see the whole picture, both before, as at and after the alleged date of insolvency. The court will be able to see whether as at the alleged date of insolvency the company was, or was not, actually paying all of its debts as they fell due and whether it did, or did not, actually pay all those debts which, although not due as at the alleged date of insolvency, nevertheless became due at a time which, as a matter of commercial reality and common sense, had to be considered as at the date of insolvency. By reference to what actually happened, rather than to conflicting experts' opinions as to the implications of balance sheets, the court's task in assessing insolvency as at the alleged date should not be very difficult.*"

10.12. This paragraph was not specifically endorsed or rejected on appeal, but has been subsequently accepted: *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant & Ors* (2008) 221 FLR 164; 68 ACSR 176 at [51]. In *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243, on appeal, Giles JA held at [103]:

> "*Unexpected later discovery of a liability, or later quantification of a liability at an unexpected level, may be excluded from consideration if the liability was properly unknown or seen in lesser amount at the relevant time.*"

10.13. This statement was made in the context of the facts of that particular case. The court excluded from consideration a disputed claim from a subcontractor in circumstances where there was a counterclaim of doubtful validity, established three years after arbitration.

10.14. It has been held that Giles JA did not enunciate any general proposition applicable to all liabilities, and those comments must be understood in the context of the facts of that case – the relevant principle was that a liability may be excluded from consideration if the liability was properly unknown, or was quantified

at a lesser amount at the relevant time: *New Cap Reinsurance Corporation Ltd (in liq) v A E Grant* (2008) 221 FLR 164; 68 ACSR 176 at [49]. The comments of Giles JA in *Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243 were also analysed by Owen J in *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1; [2008] WASC 239 at [1115] who held that the phrase "without the intrusion of hindsight" means that, when determining a company's ability to pay, it must be done according to the circumstances or state of affairs which were known or knowable at the time.

10.15. For example, a "hopelessly insolvent person who wins the lottery" or an "unexpected later discovery of a liability" (*Lewis v Doran* (2005) 219 ALR 555; 54 ACSR 410; 23 ACLC 1,666; [2005] NSWCA 243 at [95] and [103] respectively) are both examples of matters that cannot be assessed as relevant to the question of retrospective insolvency: *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* at [1115].

10.16. To be admissible, the evidence relating to retrospective insolvency must "shed light on the state of affairs at the time and on what was, or ought then to have been, known about the state of affairs": *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* at [1118]. Further, a court can use hindsight to take into account facts if the facts help determine "which version of conflicting accounts as to the state of affairs is the more likely". The fact that an event actually took place might weigh in favour of the event having taken place, but this is not determinative, being only one in a host of matters: *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* at [1116].

11. INDICIA OF INSOLVENCY

11.1. Liquidators and trustees in bankruptcy look to common indicia of insolvency to assist in identifying whether the corporation or person was insolvent at a relevant time. They may be described as 'common sense indicators' of an ability to pay the corporation's or person's debts as and when they become due and payable: *Morris v Danoz Directions Pty Ltd (In liq) (No 2)* [2010] FCA 836 at [13].

11.2. Those indicia, however, ought not to distract attention from the primary question as to whether there is an ability to pay the debts, as and when they become due and payable.

11.3. In *Australian Securities and Investment Commission v Plymin* (2003) 175 FLR 124; 46 ACSR 126; [2003] VSC 123, Mandie J at [386] referred to a number of indicia of insolvency:

- continuing losses;
- liquidity ratios below one;
- overdue Commonwealth and State taxes;
- poor relationship with bank, including inability to borrow further funds;
- no access to alternative finance;
- inability to raise further capital;

- suppliers placing company on cash on delivery or otherwise demanding special payments before resuming supply;
- creditors unpaid outside trading terms;
- issuing of post-dated cheques;
- dishonoured cheques;
- special arrangements with selected creditors;
- solicitors' demands, summonses and the like;
- payments to creditors of rounded amounts not reconcilable to specific invoices; and
- inability to produce timely and accurate financial information to indicate trading performance and financial position, and to make reliable forecasts.

11.4. Another well cited list of insolvency indicators was stated by Palmer J in *Lewis v Doran* (2004) 184 FLR 454; 208 ALR 385; 50 ACSR 175; 22 ACLC 1009; [2004] NSWSC 608, which he described at [75] as the "usual indicia of insolvency":

- a history of dishonoured cheques;
- suppliers insisting on cash on delivery terms;
- the issue of post-dated or "rounded sum" cheques;
- special arrangements with creditors (although, this may be simply due to a temporary lack of liquidity rather than an endemic shortage of such liquidity. It may also demonstrate that creditors have confidence in the financial position of the debtor);
- inability to produce timely, audited accounts;
- unpaid group tax, payroll tax, workers compensation premiums or superannuation contributions;
- demands from bankers to reduce overdraft and other evidence of deteriorating relations with bankers;
- receipt of letters of demand, statutory demands and court processes for debt.

11.5. In *Re Newark Pty Ltd (in liq)* [1993] 1 Qd R 409, Thomas J noted that, in that case, there was an absence of common indicia, namely, multiple demands, dishonoured cheques, commercial humbug and unrealistic translations. The company had stripped itself of its major stock and assets in order to honour its debts in order to carry on or start again with a very small working capital. Thomas J held that those circumstances alone "do not prove that the company is insolvent".

11.6. The presence of one or more indicia of insolvency, or other factors, may have particular significance and one or more of them may not exist: *Lewis v VI SA Australia Pty Ltd* (2008) 68 ACSR 493; [2008] FCA 1801 at [16] (Mansfield J). The fact that one or more factors of insolvency is absent does not, of itself, establish solvency: *Lewis v VI SA Australia Pty Ltd* at [16].

11.7. However, it must be remembered that the approach to determining insolvency is not a check list exercise as the entirety of the circumstances need to be considered. The weight to be attached to each of the indicia will vary in the context of the circumstances: *Deputy Commissioner of Taxation v Barblance Pty Ltd* (2010) 8 ABC(NS) 402; [2010] FCA 1121 at [11], [14] (Logan J).

CONTINUING LOSSES AS AN INDICATOR

11.8. In *Emanuel Management Pty Ltd (in liq) v Foster's Brewing Group Ltd* (2003) 178 FLR 1, Chesterman J observed at [112] that continuing losses is not, itself, an indicator of insolvency. The critical question is whether continuing losses affect a company's ability to pay its creditors: *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1; [2008] WASC 239 at [1583]. In other words, continuing operating losses erode a company's capital thereby reducing its capacity to pay its debts.

11.9. It was observed by Chesterman J in *Emanuel Management Pty Ltd (in liq) v Foster's Brewing Group Ltd*, that if money is borrowed to pay debts the liabilities increase without a corresponding increase in income to service the additional interest so that additional borrowings have a compounding effect on ongoing trading losses resulting in an ever diminishing capacity to pay debts.

11.10. Continuing losses are important in determining the security of a lender in calculating the value of assets and the position of a purchaser when negotiating price and conditions of sale which all influence the ability to realise capital out of assets to pay debts: *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* at [1590].

NON-PAYMENT OF COMMONWEALTH AND STATE TAXES

11.11. An often significant factor or indicia of insolvency is the failure to pay tax or duty commitments to the Commonwealth or State by the due date: *Australian Securities and Investment Commission v Plymin* (2003) 175 FLR 124; 46 ACSR 126; [2003] VSC 123; *Deputy Commissioner of Taxation v Interactive Community Planning Pty Ltd* [2001] FCA 1173 at [19] (Collier J).

12. CONCLUSION

12.1. Solvency is a question of fact and ascertained from a consideration of the financial position taken as a whole, having regard to "commercial realities". It is determined by application of the "cash flow" test and not on a balance sheet analysis, although that may be of assistance in the identification of assets or property available to meet financial commitments.

12.2. When pleading insolvency the better view is that the material allegation is the recitation of the elements of s 95A of the Corporations Act or s 5(2) or s 5(3) of the Bankruptcy Act.

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