Opposing Applications to Wind Up a Company in Insolvency

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1. This paper is about how a company, which has failed to set aside a statutory demand, can oppose an application to wind up the company in insolvency. The first part deals with the evidence the company can rely on in opposing the winding up application. The second part deals with what is required to prove solvency. The third part looks at what one should examine to ascertain the company's financial position. The paper assumes a basic knowledge of insolvency law, practice and procedure.

Opposing the winding up application

2. A company served with a statutory demand has two options. It can comply with the demand in which case the demand becomes satisfied and is expunged. Or it can fail or refuse to comply with the demand. If it refuses to comply with the demand because it disputes the debt claimed in the demand, or has an offsetting claim, it should apply to set the demand aside. There are strict time limits and procedures which must be followed.[1] For example the application must be made within 21 days after the demand is served and the time cannot be extended.[2] This is the same timeframe for complying with the demand. If the company fails to apply to set the demand aside, or having applied, is unsuccessful in doing so, the statutory demand matures into a presumption that the company is insolvent.[3] The

1 *Corporations Act 2001*, s. 459G
2 *David Grant v Westpac Banking Corp* (1995) 184 CLR 265
3 *Corporations Act 2001*, s. 459C(2)

presumption of insolvency operates until it is rebutted by proof that the company is solvent.[4] A company that is presumed insolvent may be wound up by the Court in insolvency.[5]

3. If the company applies to set aside the statutory demand, the Court must set the demand aside if there is a genuine dispute about the existence of the debt claimed in the demand, or if the company has an offsetting claim.[6] The Court may also set the demand aside for other reasons, namely, if substantial injustice will be caused because of a defect in the demand, or if there is some other reason it should be set aside,[7] but that is not the subject of this paper. Proof of the solvency of the company at this stage is not a ground for setting aside the statutory demand, but it has been said that it is easier to conclude that a dispute about a debt or an offsetting claim is genuine when raised by a solvent company.[8] Whilst a court would feel more comfortable setting aside a demand against a solvent company, it cannot be said that it is easier to conclude that a dispute is genuine because a company is solvent.

4. There is adequate information in the prescribed form of statutory demand to alert the company about the requirements for setting aside the demand and to warn the company of the consequences of failing to do so.[9] In my view the notice in the prescribed form does not go far enough to convey the message that the procedures and time limits are strict and cannot be extended.

5. There are many instances where a company through inadvertence, delay or for some other reason has failed to apply in time to set aside a statutory demand. If the debt claimed is genuinely disputed, an injustice may befall a company which simply decides to pay the debt rather than oppose an application which puts its very existence in jeopardy.

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4 *Corporations Act 2001*, s. 459C(3)

5 *Corporations Act 2001,* s. 459A

6 *Corporations Act 2001*, s. 459H

7 *Corporations Act 2001*, s. 459J

8 *cf. King Furniture Australia v Higgs* [2011] NSWSC 234 at [72]

9 *Corporations Regulations 2001,* Schedule 2, Form 509H

6. If the company does fail to apply to set the demand aside, or is unsuccessful in doing so, the applicant is entitled to apply for an order that the company be wound up in insolvency.[10]

7. If the company wishes to oppose the winding up application, it must file and serve a notice of the grounds on which the company opposes the application, and an affidavit verifying the matters stated in the notice.[11]

8. Until the 1993 amendments to the *Corporations Law*, a company could oppose a winding up application on the ground that there was a *bona fide* dispute about the debt claimed in the statutory demand. The existence of a *bona fide* dispute about the debt explained why the demand was not complied with and so rebutted the presumption of insolvency that would otherwise arise.

9. Under the current statutory scheme introduced in 1993, if the company does not apply to set aside the statutory demand, it cannot rely on the existence of a dispute about the debt to oppose the winding up application unless it is material to proving the company is solvent. Section 459S(1) states that a company cannot, without leave, oppose the application to wind up the company on a ground that the company relied on, *or could have relied on*, in an application to set aside the statutory demand, *whether it made such an application or not*. Leave to rely on the ground that the debt the subject of the demand is not owed, or that the company has an offsetting claim, can only be given if the court is satisfied that the ground is material to proving that the company is solvent.[12] Any dispute about the existence of the debt, or an offsetting claim, must therefore be resolved at the statutory demand stage.

10. Although the company may not be able to rely on the ground that the debt is not owed, or that it has an offsetting claim, to oppose the winding up application, those grounds, if they

10 *Corporations Act 2001,* s. 459P
11 *Corporations Act 2001*, s. 459C
12 *Corporations Act 2001*, s. 459S(2)

exist, are relevant in explaining the reason the debt has not been paid. The presumption of insolvency does not include a presumption that the debt claimed in the demand is owed and any allegation that the debt does not exist, or that there is an offsetting claim, should be included in the notice of opposition and verified in the accompanying affidavit.

11. At the hearing of the winding up application, the Court has a wide discretion to make any order it thinks fit, including the power to adjourn or stay the winding up application so as to enable any dispute about the debt to be determined in separate proceedings. It can also dismiss the application, even if presumed insolvency has been proved.[13] The outcome of the hearing depends principally on the solvency of the company in the following circumstances.

12. First, if the company is insolvent, there is no basis for any order other than a winding up order, even if there is a genuine dispute about the debt on substantial grounds.

13. Secondly, if the company is solvent, a winding up order will not be made if there is a genuine dispute about the debt.[14] As McPherson has stated, "[T]he principal reason [for this rule] is that a winding up application is not to be used for the improper purpose of compelling a solvent company to pay a disputed debt which would certainly be discharged as soon as the company's liability was clearly shown to exist."[15]

14. A winding up order in insolvency can only be made against a company that is insolvent. If the company is solvent and there is a dispute about the debt, the court will adjourn or dismiss the application to enable the dispute to be determined in separate proceedings, or it may determine the dispute itself if it depends on the construction of a document or is otherwise not one of substance.

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13 *Corporations Act 2001,* s. 467(1)

14 *Mibor Investments v Commonwealth Bank of Australia* [1994] 2 VR 290 at 293

15 McPherson, *The Law of Company Liquidation* 3rd Ed. p. 63

15. Thirdly, if there is no dispute about the debt because, for example, the debt is a judgment debt, or because an application to set aside the statutory demand was unsuccessful, or because the court finds there is no dispute in substance, the court may construe the company's failure to pay as evidence of an inability to do so. In that case the court can adjourn the application for a short time to give the company an opportunity to pay the debt and then make a winding up order if the company fails to do so. This is not uncommon in winding up and bankruptcy proceedings.

16. Fourthly, a dichotomy arises if the solvency of the company depends on the existence or non-existence of the debt, or on an offsetting claim. In such a case evidence that the debt is not due and payable is material to proving the solvency of the company and can be relied upon to oppose the application under s. 459S. This was the case in *ASIC v Lanepoint Enterprises*[16] where the High Court said that the Act " says nothing about what is to occur if there remains an issue about a debt at the time the application for an order for winding up in insolvency is heard."[17] In *Lanepoint* the existence or non-existence of the debt was critical to the solvency of the company. The Court stated that in such cases the court's power to adjourn or stay proceedings can and should be exercised where the interests of justice require.

17. In *Lanepoint* the Court stated that in this type of case a dispute about the existence or extent of a debt may be more conveniently resolved in other proceedings which have been, or will be brought, for that purpose. The Court stated that when considering whether to separate the dispute from the winding up proceeding, much may depend on practical considerations such as the nature of the dispute and the extent to which it is removed from the central question of solvency. In some cases it may be easy to determine a dispute at the hearing of the application. In other cases it may appear better for the debt to be determined in other proceedings before the winding up application is heard. The court will also bear in

16 (2011) 244 CLR 1
17 *ibid* at [32]

mind the statutory directive that winding up applications are to be determined within six months.[18]

18. A fifth scenario occurs where the company is solvent but the debt is a judgment debt which has been obtained by default and the company disputes the debt. In this situation if the court believes there are reasonable grounds for giving the company the opportunity to apply to set aside the judgment, it may adjourn the winding up application to enable the company to do so, and if the company is successful, proceed with the application in accordance with the situations in 2 or 4 above. The company's grounds for disputing the debt will be critical to the court exercising its discretion.

19. In each of the above cases (other than the first) the company must first prove that it is solvent before the court will deal with the disposition of the disputed debt.

Proving Solvency

20. There are certain practical advantages for a creditor in bringing an application to wind up a company in insolvency where a company has failed to comply with a statutory demand. In opposing the application the company will need to disclose its financial position in order to prove that it is solvent, and if it does, a significant potential obstacle to recovery of the debt is removed. On the other hand if the company is insolvent, the costs of bringing a proceeding to obtain a judgment are avoided and the process of winding up the company for the benefit of the creditors will have commenced.

21. Unless the company is insolvent, it should treat a winding up application very seriously. A winding up order can have very serious consequences for directors, shareholders, employees, customers, suppliers, bankers and creditors of the company, as well as for the

18 *Corporations Act 2001,* s. 459R

reputation of the business. I have seen companies seek to prove their solvency by producing a one-page document hastily prepared by an in-house accountant or bookkeeper setting out in very general terms the assets and liabilities of the company without proper explanation, verification or valuation. Such a document is almost useless to the court. The assertions contained in the document prove nothing about the solvency of the company and can even suggest insolvency.

22. In order to discharge the onus of proving that the company is solvent the court should ordinarily be presented with the "fullest and best" evidence of the financial position of the company.[19] Unaudited accounts and unverified claims of ownership or valuation are not ordinarily probative of solvency. Nor are bald assertions of solvency arising from a general review of the accounts, even if made by qualified accountants who have detailed knowledge of how those accounts were prepared.[20]

23. The case of *Ace Contractors v Westgarth*[21] provides a good illustration of the type of evidence required to prove solvency. In that case Westgarth was involved in the development of 33 townhouses. Ace, a contractor, served a statutory demand for $112,000 for work done. Westgarth did not comply with the demand and did not within 21 days make application to set the demand aside. Ace then applied to wind up the company and Westgarth gave notice of its intention to oppose the application on the grounds that it was solvent, and that it had a counterclaim which exceeded the amount of the claim.

24. The main issue in the case was whether Westgarth was in fact solvent. Westgarth relied on an audited balance sheet purportedly prepared in accordance with *Australian Auditing Standards* which disclosed that the company had net assets of $1.8 million. In addition Westgarth swore that it had a loan facility from a lender for $2.2 million which could be drawn down immediately to pay the $112,000 debt. Further, evidence was tendered to

19 *Commonwealth Bank of Australia v Begonia* (1993) 11 ACLC 1075 at 1081 per Hayne J.

20 *Re Citic Commodity Trading v JBL Enterprises* [1998] FCA 232.

21 [1999] FCA 728

show that settlement of the first stage of the development was scheduled to take place within 3 weeks. Certificates of occupancy for 13 units were tendered. On the basis of this material Westgarth's accountant expressed the opinion that the company had sufficient assets to meet its liabilities including the sum claimed in the statutory demand.

25. Geoffrey Kelly, a partner in the firm Greenwood Clarke, chartered accountants, was the accountant engaged by the applicant to consider and comment on the company's audited balance sheet. He was a Fellow of the Institute of Chartered Accountants, a registered liquidator and an official liquidator of the Supreme Court and Federal Court. He had extensive experience in the investigation of company books and records and in the analysis of accounting entries and had conducted investigations into the solvency of companies. He expressed the opinion that for a number of reasons it was not possible to conclude, on the basis of Westgarth's audited financial statements, that the company was solvent.

26. Weinberg J held that Westgarth had failed to put before the court the fullest and best evidence of solvency and that it had thereby failed to rebut the presumption of insolvency. One of the reasons for arriving at this conclusion was that a balance sheet is nothing more than a statement of the position of a company at a particular point in time. He stated that in this case one could not properly conclude that Westgarth was solvent merely because its assets were said to exceed its liabilities. What was needed was a series of cash flow projections. It was the projected cash flow which would show whether or not the company had, and would have, sufficient funds to pay debts as and when they became due.

27. In respect of Westgarth's reliance upon its drawdown facility, his Honour held that it was not supported by any evidence from the lender as to its willingness or ability to continue to fund the project. His Honour said that there was no evidence led of the terms upon which the drawdown facility could be utilised, nor whether the amount of the facility would be reduced once settlement of the first stage of the project occurred. No documents relating to the drawdown facility were tendered in evidence.

28. His Honour held that despite the bald assertions that Westgarth was solvent and that it could within a short period of time rely on the drawdown facility to meet the debt claimed by the applicant, he was not satisfied that this was so.

29. However, although Westgarth had failed to rebut the presumption of insolvency, the Court exercised its discretion to decline to make a winding up order. Two of the reasons his Honour gave for not making the order were first, that an application to set aside the statutory demand had been made but dismissed because it was out of time. The company had at least made some attempt to challenge the demand. Secondly, although Westgarth had failed to prove solvency, the evidence did not demonstrate that the company was in fact insolvent. The applicant had not contended that Westgarth was insolvent, only that it had failed to discharge the onus of proving that it was solvent. His Honour said that "notwithstanding the effect which the court must give to the presumption, and to the company's failure to discharge the onus of demonstrating actual solvency, Westgarth may, in reality, be solvent."[22]

30. As stated above, the court has a discretion to make any order it thinks fit, even if presumed insolvency has been proved. In *Westgarth* the dispute about the debt claimed in the statutory demand, or the existence of an offsetting claim, was not material to proving the company was solvent. Thus the company could not rely on those grounds to oppose the application. However his Honour must have found that there was no genuine dispute about the debt because he adjourned the application for 14 days on the basis that if the sum claimed in the statutory demand was paid, the winding up application would stand dismissed. He said that the cross claim, which could take months or years to resolve, could be sorted out in other proceedings between the parties.

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22 *ibid* at [53]

31. What is significant about *Westgarth* is the applicant's opposition to the company's proof of solvency. The applicant appears to have gone to considerable lengths to contest the company's claims of solvency. Westgarth maintained throughout that it was in a position to pay the sum claimed in the statutory demand within a relatively short time simply by drawing down on its loan facility. The applicant submitted that if the Court exercised its discretion in favour of the company by not making a winding up order, that proposition could be put to the test. What the applicant achieved by contesting the company's proof of solvency was payment of its debt without becoming bogged down in proceedings involving the company's counterclaim which could take years to resolve.

Understanding the company's financial position

32. The most effective way of presenting a company's financial position is by means of a detailed set of audited accounts. The main accounts are a balance sheet and a profit and loss statement, but there can be others. An audit is an independent examination of the books and records to verify that the accounts present a true and fair picture of the company's financial position. The independence of external auditors is crucial to the credibility of the audit report. If an auditor has a partial relationship with its client, the objectivity of the audit could be, or could be perceived to be, impaired. In *Westgarth*, Weinberg J described the audit report produced by the company as *purportedly* prepared in accordance with *Australian Auditing Standards*. The accountant who prepared the report on behalf of the company was the company's accountant. This was clearly not lost on the judge.

33. In addition, the fact that the judge expressed the view that there was insufficient verification of the loan facility suggests that there was a question mark over the audited accounts. Where accounts have been properly audited there should be no need to seek further verification.

34. In considering the question of solvency, what is critical is the nature of the company's assets and its ability to convert those assets into cash within a relatively short space of time to the extent of being able to pay all debts as and when they fall due. This is the cash flow test of solvency prescribed by s. 95A of the *Corporations Act*. In *Westgarth* the company was said to have net assets of $1.8 million but that did not necessarily mean that the company was able to pay all its debts as and when they fell due. There is a difference between solvency and a surplus of assets.

35. The cash flow test is a comparison between the *current* assets and the *current* liabilities of a company. Current assets are assets which can be converted into cash within a relatively short space of time. They include stock, debtors or accounts receivable, short-term bank deposits and cash. Current liabilities are liabilities that must be paid within normal trading terms. They include trade creditors and accounts payable, accrued expenses, bank overdrafts and short-term borrowings, interest on borrowings and overdrafts, and debts or repayments that need to be paid in the short term.

36. If current assets exceed current liabilities, there should be sufficient cash flow to maintain operations. On the other hand if current liabilities exceed current assets, the business may find it difficult to pay its debts on time.

37. It is important to note that the definitions of solvency and insolvency in

s. 95A do not require the company to be able to pay all its debts as and when they become due *from the company's own cash reserves.* Regard may be had to resources from which it may obtain funds within a relatively short space of time such as borrowing, selling assets and capital raising. However short-term loans to pay debts or loans repayable on demand do not enhance solvency.[23] Such loans merely substitute one form of immediate obligation for another. A loan from a third party to a company experiencing liquidity problems must be

23 *ASIC v Edwards* [2005] NSWSC 831 at [99]

demonstrated cogently to be either legally enforceable or commercially realistic.[24] Short-term loans on onerous terms reflective of risk do not demonstrate solvency.

38. Whilst a balance sheet provides a snapshot of the company's financial position at a particular point in time, a profit and loss statement shows the operating profit (or loss) of the business. The net operating profit or loss is derived after deducting the expenses incurred by the business in carrying on its operations from its income during the reporting period. But losses do not necessarily mean the business is unprofitable or insolvent. For example, in its initial years, a start up business can incur losses for various reasons. These losses are carried forward and set off against later profits. The solvency of the business in such instances depends on its reserves of capital or access to funds.

39. The profit and loss statement is a good measure of the cash flow of the business because it reflects what monies the company should have on hand to pay creditors after carrying on its normal operations. In *Westgarth*, because of the nature of the business, a property development, a statement of projected cash flow was a more appropriate measure of the funds the company would have available to pay creditors upon settlement of the sales of the units.

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24 *ibid* at [98]