ON THE BEAM

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FORENSIC INSOLVENCY TURNAROUND
ASSOCIATES

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# Enter the Teens!

By Schon G Condon RFD

Happy New Year and welcome to 2010. Gone are the Naughties and now we can enter the Teens with interest and a positive frame of mind.

Even though we are only a few weeks into the new decade and business is not yet into the full swing of things for the year, there has still been an amazing variety of news that has popped up.

2009 ended with many Australians happy for it to be over and to see the back of the Global Financial Crisis. This was certainly reinforced by the Stock Market reaching its highest levels since 2008 - very quickly I must add.

However, 2010 begins with much talk in the market regarding the limited future of video stores and travel agencies. This is due to their respective markets being overrun by technology that has changed the way consumers acquire their products and knowledge. Consumers no longer need to visit a travel agent or video store, when they can do it all from the comfort of their own home with the simple click of a mouse. This shouldn't come as much of a surprise as this has been predicted for some time now and measures should have been taken by those in these industries well before now. While there will definitely be changes - and businesses that will close - those businesses that provide a truly memorable customer experience for a genuinely fair price are more likely to survive.

Next, that old chestnut - the Australian Taxation Office (ATO) - is once again in the news as they plan on going out again and savaging the Small and Medium Enterprise (SME) sector by increasing their attention on defaulting taxpayers. The main targets here are not those that have managed through the tough times but those that are habitual non payers of tax.

Tough times can often provide opportunities for leniency from many quarters, alas many business owners don't focus on the real information to prop up a failing concern. It is extremely important to focus on the important information and when it doesn't look good - as I always say - take action early. Doing the same thing day in and day out and expecting a different result will only ultimately provide disappointment and financial loss.

In other news, many in the industry are predicting a boom in the unit market in Australia, yet the property market in the US continues to fail. Car sales are gradually improving but other areas are failing and there is the ever present threat of further interest rate rises.

All in all, I think we will be in for an interesting year and decade.

Finally, we also enter the new decade with a Senate Inquiry into the Insolvency industry. Let us all hope that it is productive and achieves something positive. I'd like to see progressive steps taken to ensure positive returns to creditors, the maintenance of sound businesses and the resulting trade and employment that go with them. For those of you interested in this Senate Inquiry submissions need to be lodged by February 12 if anyone wishes to do so.

Enjoy the read and once again – happy New Year!!

**Inside this issue:**

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## *Deposits and Prepayments*

By Robert Kite

Many of us accept that it is common practice when purchasing goods at the retail level that in order to have the merchant request the goods from the supplier, they will require the customer to leave a deposit.

This in itself is acceptable to both the supplier and the consumer as we accept that the supplier does not want to have ordered goods on behalf of a customer who does not return to pay for and collect the goods. The deposit acts as a kind of surety such that the customer will want to return to complete the purchase.

In most cases, the goods will be delivered to the merchant, the consumer will pay any remaining balance owing on the goods, collect them and the sale will be completed.

But what happens if you have left your deposit, or have part paid a lay-by, or worse still, paid in full but are yet to receive delivery for the goods and the retailer goes into liquidation.

In these cases the customer will be an unsecured creditor, and in most cases the customer will have lost whatever monies have been paid to the company up to the date of the liquidation.

In the case of many retail situations, if the customer has left a deposit or part paid a lay-by the customer will have lost a lesser sum of money. In some cases however, the customer may have been saving for a long time and has paid $1,500 in cash on an electrical item expecting their electrical appliance to have been delivered within a certain period of time and the appliance is never delivered and the company goes into liquidation. This customer will be an unsecured creditor in the liquidation of the company, and will rank equally with all other unsecured creditors. In many cases the customer in this example will have lost their $1,500.

Whether the consumer realises it or not, by paying for goods in advance, they are in effect lending money to the merchant company, which substantiates their position as a creditor of the company.

When seeking to pay a deposit or pay for the goods awaiting delivery, most people assume the business will honour the transaction and their goods will be delivered. As the consumer is advancing credit to the merchant company, they are never given the opportunity to explore the true position of the business, they just assume, as do most people, that the transaction will be completed with minimal fuss.

In light of the risk of each of the above scenarios, the following is a brief listing of ways to minimise such risks for deposits and prepayments:

1. Do not pay anymore than the minimum sum for the deposit.
2. Minimise the amount of time goods are kept under lay-by.
3. If possible, only make a full payment at the time you are ready to collect the goods from the store. Do not pay full price on the basis that it will be ordered in, leave a minimum deposit instead.
4. Pay your deposit or payment by credit card. In certain circumstances, if your goods are not delivered, the credit card provider will refund the purchase price/deposit to your credit card and they will seek to address the situation with the retailer.

The above demonstrates what happens in reference to a retail transaction, for which there may be some lesser sums involved, however, let's now consider when a vendor sells an item of real estate.

It is commonly the practice that when selling an item of real estate that upon the execution of the contract for sale, a deposit of (usually) 10% is paid to the estate agent for which they should bank the funds into their Trust Account. Upon settlement of the sale, the estate agent will deduct any commissions payable to the agent and account for the balance to the vendor (assuming there are sufficient funds to pay the mortgagee and other settlement adjustments).

Take the example that the item of real estate is sold for $500,000 and a 10% deposit ($50,000) is being held by the agent. There are sufficient funds from the sale to discharge the mortgagee and settlement adjustments from the remainder of the purchase price. After the agent deducts their commission of 2.8% ($14,000), a balance of $36,000 should be returned to the vendor.

*If the estate agent is placed into liquidation, and there are insufficient funds in the Trust Account to return the $36,000 to the vendor, the vendor in this instance will become an unsecured creditor in the liquidation. (It is accepted that the funds should have been held in trust and dealt with accordingly, but in this instance it is assumed that the Trust Account has not been administered correctly).*

Now given that most people believe that the estate agent will honor their end of the agreement by returning and surplus funds to them as do most people in the retail scene as discussed above, the possibility of not receiving the surplus funds is not given a second thought. However, if the same person were looking to provide credit to someone for a similar level of funds, I can only imagine they would exercise far more caution and diligence prior to advancing such a significant level of funds.

The best way to seek to mitigate the risk associated with the above scenario is to stipulate under the contract for sale that the deposit is to be held by the vendor's solicitor.

Therefore, under the above scenario, upon the exchange of contracts, the $50,000 will be held in the solicitors Trust Account until settlement, following which, the estate agent will be paid their commission for the sale and the surplus funds will be returned to the vendor.

In the event that the solicitor's Trust Account is deficient, i.e., the $50,000 is no longer there to pay the estate agent's

commission and surplus funds to the vendor, the vendor can seek to lodge a claim under the Legal Practitioners Fidelity Fund via the Law Society of NSW[1] .

As no such equivalent provisions are in place for Real Estate Agents Trust Accounts at this time, the fact that there is the possibility of a recovery from the Legal Practitioners Fidelity Fund in the event of a worst case scenario, provides a greater sense of comfort than is otherwise available by leaving the deposit within the real estate agent's Trust Account.

## *Has the law gone soft on insolvent trading?*

Mark Franklin - Consultant

The Corporations Act provides for civil and criminal sanctions against directors (and shadow directors) for insolvent trading.

Section 588H provides directors limited defence to civil insolvent trading actions.

However, Sections 1317S and 1318 of the Corporations Act gives the Courts discretion to excuse directors either wholly or in part from liability for insolvent trading.

ASIC have issued Consultation Paper 124 Duty to prevent Insolvent Trading: Guide for directors, which was issued on 24 November 2009 and sought comments and submissions by 22 January 2010.

The consultation paper appears to have been issued in a rebellious response to several recent Court decisions which appear to give directors leniency when civil action has been taken by liquidators against directors for insolvent trading.

The paper outlines ASIC's proposals to help directors understand and comply with their duty to prevent insolvent trading and seeks to reinforce the insolvent trading provisions as currently provided by the Corporations Act.

According to ASIC the principles directors need to be aware of are:

- Must keep him or herself informed about the financial affairs of the company and regularly assess the company's solvency;
- Immediately on identifying concerns about the company's viability, should take positive steps to confirm the company's financial position and realistically assess the options available to deal with the company's financial difficulties;
- Should obtain appropriate advice from a suitably qualified person; and
- Should consider and act appropriately on the advice received in a timely manner.

The Law Council of Australia and Senior Barrister Leon Zwier made submissions to Treasury during 2009 seeking changes to the insolvency provisions of the Corporations Act to essentially expand the defence available to directors under Section 588H to make them sufficiently flexible and fair to assist directors to engage in meaningful and honest restructuring without the concern of being found liable for insolvent trading if the attempt fails.

The submission has been made following comments by Robson J in Re Locktronic Systems Pty Ltd (in liquidation) (receivers appointed) (No 2) (2009) VSC 533 whom asked senior counsel to draw his comments to the attention of legislators " because I think this is a classic case which demonstrates that the flaw needs to be adjusted."

Robson J further commented the three directors were "honest men who were seeking to save the company they had worked so hard to make a success of "and further noted the prospect of recapitalising the company "does not appear to be sufficient (to shield directors) under our present law."

He also went on to say the consequences of the law in its current state were "not in the interests of creditors".

In Hall and Ors v Poolman and Ors (2007) NSWSC 1330, Palmer J decided as a director acted honestly he was relieved of an insolvent trading liability pursuant to Sections 1317S and 1318 of the Corporations Act for 3 months after he was aware of the company's insolvency as "it was sometimes a difficult decision for a director of a trading corporation suffering from liquidity problems to decide whether , and when, to abandon hope of a change in the company's fortunes and to summon the Administrators."

In a more recent case, The Stakeman Pty Ltd v Caroll (2009) FCA 1415 Goldberg J found the director to have breached Section 588G of the Corporations Act and while he was not able to rely on the defence in Section 588H was nevertheless excused from liability under Section 1317S as the judge stated "to adopt and adapt the words of Hamlet, *to trade or not to trade, that is the question.*"

Nothing in the draft Regulatory Guide attached to ASIC's Consultation Paper is supposed to affect the ability of a liquidator of a company to bring proceedings against the company's directors to recover compensation for loss resulting from insolvent trading, or that of the company's creditors to bring similar action if they have first obtained the liquidator's consent or the leave of the Court.

However, it appears the legal fraternity is seeking to make insolvent trading recovery from directors even harder for liquidators than has already been the case and they will have to be even more careful in future unless they themselves get costs awarded against them for trying to recover funds for creditors.

It will be interesting to see if ASIC who appear to be maintaining a hard line on insolvent trading will back up that position with more insolvent trading prosecutions. To do so, they will require Treasury's support with increased funding. Somehow I have my doubts.

[1] Please refer to the Law Society of NSW in relation to the application of the Legal Practitioners Fidelity Fund

## *Gambling and Bankruptcy*

By Alex Frazer

It's no secret that Australia has a long established and ever-increasing penchant for gambling. Since 2001, adult Australians have lost over $14 billion dollars annually on gambling. This is the equivalent of over $1000 dollars for every adult Australian. This trend towards enjoying a 'punt' has had some serious social consequences. In 2004-2005, it was estimated that over 500 Australians became bankrupt (this is a conservative estimate). This article will discuss how gambling is treated under Bankruptcy legislation. It outlines how gambling is treated under bankruptcy legislation and evaluates current sanctions put in place to deal with gambling behaviour.

Some of the consequences of problem gambling that you or someone around you may be exposed to are:

- Argumentative or secretive behaviour due to gambling
- Cannot pay bills and use the money for gambling instead
- Creditors unable to be repaid after lending money to a problem gambler who cannot make repayments
- Constantly applying for additional credit with lending institutions
- Sexually transmitted debt – being liable for debts incurred by your spouse or partner
- Sold or seized assets as a result of funding for problem gambling

Section 271, of the Bankruptcy Act (1966) has addressed some of these issues as follows:

*a) within 2 years before the presentation of the petition on which, or by virtue of the presentation of which, he or she became a bankrupt, whether the petition was presented before or after the commencement of this Act, materially contributed to, or increased the extent of, his or her insolvency; or*

*(b) during any period between the presentation of that petition and the date on which he or she became a bankrupt, lost any of his or her property;*

*by gambling or by speculations that, having regard to his or her financial position at the time and any other material circumstance, were rash and hazardous, being gambling and or speculations not connected with a trade or business carried on by him or her, is guilty of an offence and is punishable, on conviction, by imprisonment for a period not exceeding one year.*

Gambling is the third most likely and fastest growing cause of bankruptcy in the western world and second most likely within Australia[1]. This may come as a surprise to some but this is due to the massive understatement of gambling recognition listed in a bankrupt's state of affairs. The above legislation attempts to tackle the consequences of gambling by punishing gamblers who increase their insolvency or lose material assets through hazardous gambling and speculations prior to presentation of a bankruptcy petition. It would be interesting to note how many gamblers would be aware of such legislation, given it seems to be a punishment for offences applied in retrospect. This legislation was more likely developed to protect creditors from fraudulently using money to speculate or gamble. However, section 271 has been criticised for its limited use and shallow impact in dissuading gambling behaviour. The Insolvency and Trustee Service Australia (ITSA), has noted that *'it will not refer a case to prosecution where it appears he debtor would be a "problem gambler" and had not engaged in any associated criminal activity to finance their gambling habit.[2]'* In turn, this appears that the punishments for such an important and growing cause of bankruptcy are not dealt with accordingly in legislation and masks the damage that it can do to parties related to the bankrupt.

There is the potential for gambling and problem gamblers to cause significant damage to the finances of creditors, friends and family. The current provisions in the Bankruptcy legislation are limited at this current point in time and do not significantly address the issues of problem gambling and bankruptcy both before and during the bankruptcy period. This leaves room for the bankrupt to manipulate the bankruptcy system and accrue significant debts prior to a bankruptcy petition. Insolvency practitioners will look to pressure government regulators in the coming years to address these issues and develop legislation which has a strong response to gambling issues and the accrual of debts prior to bankruptcy. This may well result in increased enforcement, more lengthy imprisonments, and a tougher stance on the garnishing of wages.

The next time you, one of your friends, or family are thinking of having a bet, make sure it is manageable and not with borrowed money. Otherwise, you or someone you know could end up being part of a growing statistic and one of the first to be affected by regulators increasing response to bankrupt gamblers.

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1 Insolvency and Trustee Service Australia, *Annual Report 2004-2005 as cited in Duns, J. (2007)*

*2 Insolvency and Trustee Service Australia, Referral of offences under Section 271 of the* Bankruptcy Act 1966 *(Rash and Hazardous Gambling)(2006) as cited in Duns,J. (2007) <http://www.itsa.gov.au/dir228/itsaweb.nsf/docindex/About%20Us-%3EPublications-%3ECorporate%20Plan%20Document/$FILE/s271_referral_policy.pdf>*

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