

**LEGAL PROFESSION ADMISSION BOARD**

**SEPTEMBER 2008**

**INSOLVENCY**

**TIME: Three Hours.**

The paper consists of **six** questions.

Candidates are required to attempt any **five (5)** questions.

No question is compulsory.

All questions are of equal value.

If a candidate answers more than the specified number of questions, only the first **5** questions attempted will be marked.

All questions may be answered in one examination booklet.

Each page of each answer must be numbered with the appropriate question number.

Candidates must indicate which questions they have answered on the front cover of the first examination booklet.

Candidates must write their answers clearly. Lack of legibility may lead to a delay in the candidate's results being given.

**Permitted Material:**

**This is an open book examination. Candidates may refer to any books and any printed or handwritten material they have brought into the exam room.**

**As some instances of cheating and of bringing unauthorised material into the examination room have come to the attention of the Admission Board, candidates are warned that such conduct will result in instant expulsion from the examination and may result in exclusion from all further examinations.**

*This examination should not be relied on as a guide to the form or content of future examinations in this subject.*

### **Question 1.**

Short terminated his law partnership with his wife Shystress to develop computer software that made share market predictions. Short transferred his assets to Shystress as trustee of a discretionary trust with Shystress and their son Seamus as the class of objects. Shystress had discretion to remit income to herself for family living expenses and to charge management fees for her services. Short also transferred his half interest in their family home to Shystress. The trust and transfer of the real estate interest to Shystress were completed on 1 January 2004.

On 1 July 2005 Shystress raised \$250,000 for Short's business from clients of her legal practice without disclosing her relationship to Short. The clients were issued with a loan certificate by Short guaranteeing repayment of money advanced at 8% interest per annum with capital repayable on demand from 1 January 2008. The clients were shown a balance sheet of the assets held on trust without disclosure that Short had no beneficial interest in the trust.

On 1 January 2006 Short paid \$200,000 into the trust managed by Shystress. From then on half yearly profits made by Short from the sale of software packages were paid into the trust controlled and managed by Shystress. On 1 July 2006 Shystress paid interest of \$20,000 on the loan certificates out of the trust.

On 1 July 2007 Short hired lawyers to defend a law suit for losses on the futures market brought by purchasers of Short's software. Short received a notice of assessment to income tax for \$100,000 that expired on 1 January 2008. Shystress paid interest of \$20,000 on the loan certificates out of the trust.

By 31 December 2007 \$100,000 in profits had been paid into the trust. Shystress then paid \$50,000 in private school fees to Posh College for Seamus and \$50,000 to herself as management fees. Short received a legal bill for \$100,000 that he was unable to pay from his own resources.

On 1 January 2008 Short defaulted when demand was made on the loan certificates and presented a debtor's petition to become a bankrupt. Short filed a verified statement of affairs that he was insolvent and had minimal assets in support of his debtor's petition.

**Short's creditors seek your advice as to Short's actions. Advise the creditors.**

**(20 marks)**

**(Question 2 follows)**

## **Question 2.**

Erica conducted a modelling agency from a terrace house she leased for \$2,500 per month from Chic Premises Pty. Ltd. Erica paid the expenses of the modelling agency from an overdraft account with the Rapacious Bank that was limited to \$40,000.

As at 1 January 2008 Erica was overdrawn on the overdraft that had a debit of \$50,000. The Rapacious Bank dishonoured a cheque drawn by Erica for \$2,500 to Chic Premises Ltd for her monthly rental. Chic Premises Pty. Ltd threatened Erica that should she default on her rental obligations her monthly lease would be terminated and Chic Rental Pty. Ltd. would re-enter the premises and take possession.

As at 1 February 2008 Erica was insolvent but was determined to trade out of her difficulties. She entered in to an agreement with the Rapacious Bank to bank all her takings from the modelling agency with the Bank allowing the Bank to deduct \$10,000 per month in permanent reduction of her overdraft. She also gave the Rapacious Bank a bill of sale over her Ferrari for all indebtedness under her overdraft. The Bank promptly registered its interest in the Ferrari under the Registration of Interests in Goods Act. In return the Rapacious Bank promised to honour all cheques payable to Chic Premises Ltd. for rent in priority to cheques to other creditors of the modelling agency.

On 1 March 2008 Erica purchased photographic equipment for \$10,000 from Still Life Pty. Ltd. The photographic equipment was for a forthcoming trip to Africa with an agency model for a fashion shoot to promote a newly created wildlife magazine that Erica believed would be a large commercial success. She paid all her rent with Chic Premises Pty. Ltd. up to 1 May 2008 by cheque for \$10,000 drawn on the overdraft with the Rapacious Bank. She also drew a cheque to pay for the trip to Africa for the model and herself with Continental Travel Ltd.

On 1 April 2008 Erica flew to Africa with the model for the photographic shoot. While in Africa she fell in love with a big game hunter and her relationship was the subject of salacious press reports in Australia. The wild life magazine refused to pay for the photographs claiming Erica's relationship with the big game hunter compromised the marketing campaign for the magazine.

On 21 April 2008 Erica redeemed her return ticket to Sydney with Continental Travel Ltd for \$2,000. On 1 May 2008 the model returned to Sydney but Erica remained behind with her lover in Africa. Repeated texts to her mobile phone by agency models looking for work remain unanswered. Rapacious Bank has received \$50,000 including an amount of \$20,000 for sale of the Ferrari that was subject to the bill of sale for Erica's overdraft.

**(Question 2 continues)**

**(Question 2 continued)**

Chic Premises Ltd has terminated Erica's lease and on 1 June 2008 obtained an order for possession of the terrace house where Erica carried on the modelling agency and judgment for \$2,500 for rent up to the date of judgment. The model claims she has not been paid by Erica for her work in Africa.

- (a) Can any of Erica's creditors present a petition on 1 July 2008 seeking a sequestration order against Erica's estate?**
- (b) If Erica is made bankrupt by any of her creditors on a petition presented on 1 July 2008 when will Erica's bankruptcy commence and what transactions, if any, are void against her Trustee in Bankruptcy?**

**(20 marks)**

**Question 3.**

Abbot and Costello were the sole directors and shareholders of Illustrious Pty. Ltd. a trustee of a trading trust with nominal corporate assets and \$500,000 trust assets. The sole beneficiaries of the trading trust were the wives of Abbot and Costello that had no active part in the business. The business of the trading trust was the acquisition and modernization of discarded military reconnaissance aircraft that were sold to wealthy aviation enthusiasts. The business of Illustrious Pty. Ltd. required significant capital investment over a ten year period to completely refurbish the aircraft with modern technology.

On 1 January 2005 to raise capital for the business Illustrious Pty. Ltd. issued a redeemable convertible note to Trump for \$500,000 that was convertible from 1 January 2008 with a redemption value of \$1 million. Abbot provided Trump with a balance sheet for Illustrious Pty. Ltd that failed to disclose that the assets of the business were held by Illustrious Pty. Ltd. as trustee. Trump purchased the redeemable convertible note on the basis of the representations by Abbot. The \$1 million raised was paid into the trust leaving Illustrious Pty Ltd. with nominal assets.

On 1 February 2005 Illustrious Pty. Ltd. entered into a contract to purchase jet engines for \$1 million from Jetscam Pty. Ltd a company controlled by Costello and his wife. The market value of the jet engines was \$100,000. The contract provided for Illustrious Pty. Ltd. to take possession of the jet engines but title did not pass until the purchase price was paid.

**(Question 3 continues)**

**(Question 3 continued)**

Stalin Ltd. was a steel fabricator that carried out structural steel work on airplanes for Illustrious Pty. Ltd and was owed \$200,000 for work completed. The contract between Illustrious Pty. Ltd. and Stalin Ltd. provided that Stalin Ltd. could sever the structural steelwork from the stock of Illustrious Pty. Ltd. if all amounts outstanding were not paid within 21 days of demand by Stalin Pty. Ltd

On 1 January 2008 Stalin Ltd served a statutory demand upon Illustrious Pty. Ltd for \$200,000. Stalin Ltd served notice on Illustrious Pty. Ltd. that it was entitled to sever structural steelwork from the airplanes pursuant to its contractual rights with Illustrious Pty. Ltd. Illustrious Pty. Ltd made a distribution of \$500,000 each to the wives of Abbot and Costello as beneficiaries of the trust. Illustrious Pty. Ltd paid \$1 million to Jetscam Pty. Ltd immediately after the statutory demand was served. As a result of the payment to Jetscam Pty. Ltd. there was not sufficient capital in the trust to pay the creditors of the trust business carried on by Illustrious Pty. Ltd.

On 14 January 2008 Illustrious Pty. Ltd. defaulted when Trump sought to redeem the convertible note for \$ 1 million.

On 1 February 2008 an application to wind up Illustrious Pty. Ltd. was made in the Supreme Court by a trust creditor. A provisional liquidator was appointed who took control of the airplanes in possession of Illustrious Pty. Ltd. The provisional liquidator obtained a freezing order over \$250,000 in an account held by Jetscam Pty. Ltd. The costs of the provisional liquidator in obtaining the freezing order were \$ 50,000.

On 1 March 2008 a liquidator was appointed over Illustrious Pty. Ltd. who called upon the provisional liquidator to hand over all assets under her control. The provisional liquidator refused claiming that she had security for her costs, charges and remuneration in obtaining the freezing order against Jetscam Pty. Ltd.

**The liquidator seeks advice on the winding up of Illustrious Pty. Ltd and payment of the costs charges, expenses and remuneration of the provisional liquidator and liquidator arising out of the winding up.**

**(20 marks)**

**(Question 4 follows)**

#### **Question 4.**

On 1 January 2004 Robbie and Bobbie were partners in a printing business that they sold to a company they incorporated called 2 Bob Pty. Ltd becoming its sole directors and shareholders. 2 Bob Pty. Ltd paid \$2 million for the printing business that only had a market value of \$1 million. 2 Bob Pty. Ltd financed the purchase by vendor finance from Robbie and Bobbie through the acceptance of two promissory notes for \$1 million each to mature on 1 March 2008. 2 Bob Pty. Ltd insured its business premises and equipment with Fair Dinkum Insurance Ltd paying \$10,000 in premiums per annum.

2 Bob Pty. Ltd purchased a high technology printing press from Metalworks Pty. Ltd for \$1 million on credit. The contract of acquisition provided that title to the printing press would pass to 2 Bob Pty. Ltd but would revert in Metalworks Ltd if an application to wind up 2 Bob Pty. Ltd was made by a creditor. 2 Bob Pty. Ltd was given a license to use the machine provided 50% of all income made from use of the machine were to be held on trust for Metalworks Pty. Ltd in permanent reduction of the purchase price. 2 Bob Pty. Ltd was required to insure the printing press for \$1 million.

Robbie and Bobbie had a bitter falling out when Robbie discovered that Bobbie was having an affair with his wife, Betty. On 2 July 2007 a fire destroyed the factory premises of 2 Bob Pty. Ltd in suspicious circumstances. 2 Bob Pty. Ltd immediately made a claim for \$2 million on its policy with Fair Dinkum Insurance Ltd who sent in investigators to discover the cause of the fire. The fire destroyed all the books and records of 2 Bob Pty. Ltd who could no longer carry on business to fulfil its contractual obligations. On 1 December 2007 Fair Dinkum Ltd. declined liability under the insurance policy with the result that 2 Bob Pty. Ltd could only restore its capital by successful litigation against Fair Dinkum Pty. Ltd.

2 Bob Pty. Ltd was owed \$200,000 by Media Outlets Ltd for printing magazines for distribution throughout Australia. On 1 January 2008 2 Bob Pty. Ltd directed Media Outlets Ltd. to pay \$100,000 to Metalworks Ltd for the high technology printing press that was destroyed in the fire. 2 Bob Pty. Ltd agreed to forgive the rest of the \$100,000 owed by Media Outlets Ltd in return for Media Outlets Ltd paying \$100,000 to be held on trust by 2 Bob Pty. Ltd for certain magazine publishers that were clients of Media Outlets who had used the printing services of 2 Bob Pty. Ltd. 2 Bob Pty. Ltd had accumulated \$400,000 in the trust fund to pay Metal Works Pty. Ltd for the printing press.

On 1 March 2008 Robbie and Bobbie held a joint director and shareholders' meeting and a resolution was passed assigning all commercial contracts of 2 Bob Pty. Ltd to a new company formed by Robbie called Fidelity Pty. Ltd. Robbie agreed to forgive all amounts outstanding to him by 2 Bob Pty. Ltd on the promissory note that had now matured.

**(Question 4 continues)**

**(Question 4 continued)**

On 1 April 2008 an application was made to wind up 2 Bob Pty. Ltd in insolvency and a winding up order was made appointing a liquidator on 1 May 2008.

**The liquidator wants advice concerning the validity of the transactions entered into by 2 Bob Pty Ltd and any action the liquidator should take for the benefit of the creditors of 2 Bob Pty. Ltd. Advise the liquidator.**

**(20 marks)**

**Question 5**

“The judgment is never conclusive in bankruptcy. It does not always represent itself as the relevant debt of the petitioning creditor, even though under the general law, the prior existing debt has merged in a judgment. But the Bankruptcy Court may accept the judgment as satisfactory proof of the petitioning creditor’s debt. In that sense that court has a discretion. It may or may not so accept the judgment. But it has been made quite clear by the decisions of the past that where reason is shown for questioning whether behind the judgment or as it is said, as the consideration for it, there was in truth and reality a debt due to the petitioning creditor, the Court of Bankruptcy can no longer accept the judgment as such satisfactory proof. It must then exercise its power, or if you will, its discretion to look what is behind the judgment: to what is its consideration. It is not the law, in my opinion, that whether in any case the Court of Bankruptcy will consider whether there is satisfactory proof of the petitioning creditor’s debt is a mere matter of its own discretion.” (Barwick C. J. *Wren v Mahony* [1972] HCA 5 at paragraph 16)

**Discuss with reference to section 52 (1) (c) of the Bankruptcy Act.**

**(20 marks)**

**Question 6.**

“In my opinion, s.95A (of the Corporations Act) requires the court to decide whether the company is able, as at the alleged date of insolvency, to pay all its debts as they become payable by reference to the commercial realities. If the court is satisfied that as a matter of commercial reality the company has a resource available to pay all of its debts as they become due and payable then it will not matter that the resource is an unsecured borrowing or a voluntary extension of credit by another party.” (Palmer J. in *Lewis v Doran* (2004) 208 ALR 385 at 116)

**Discuss with reference to proof of insolvency by a liquidator. How is the problem of proving insolvency by an unsecured creditor seeking to wind up a company in insolvency alleviated by the provisions of the Corporations Act?**

**(20 marks)**

**- END OF PAPER -**