Articles

Insuring against insolvency risk

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Introducing insolvency risk

What is insolvency risk?

Insolvency risk is the risk of a person becoming insolvent. That person can be a natural person, a corporation or some other entity.[1] While one's own insolvency is always an important concern, in the context of insurance policies, insurance against the risk of insolvency is usually insurance against the risk that some other person will become insolvent, and thereby cause the insured an insurable loss. Before identifying those persons against whose insolvency one may wish to purchase insurance, it is necessary to first understand what insolvency is.

What is insolvency?

Section 95A of the Corporations Law is headed "Solvency and insolvency". Subsections (1) and (2) provide as follows:

> (1) 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.
> (2) A person who is not solvent is insolvent.

Most other legislation that addresses insolvency incorporates the Corporations Law approach to the definition.[2]

So the first fundamental is that it no longer matters terribly much that assets sometimes are exceeded by liabilities on a corporate balance sheet. Almost every trading entity, particularly growing entities, will encounter a net asset deficiency from time to time. What is important is that a corporation is able to pay all of its debts as and when they become due or payable.

The cash resources to be taken into account in applying the test will include loans which can be drawn down or readily accessed, and subscriptions for

* Barrister, 5th floor, Wentworth Chambers, Sydney. This article is based upon a paper presented by the author at the IIR 1999 Insurance Law and Litigation Congress held in Sydney, 15 and 16 March 1999. The author thanks Ronda Broadbridge, recently retired Head of Claims and Recoveries, Export Finance and Insurance Corporation, Arthur Davis, Middleton Moore & Bevins, James Franklin, American Home Assurance Company (AIG), James Melrose, Trade Credit and Financial Risks Manager, FAI Insurance Group, Nigel Rein, Ground Floor, Wentworth Chambers, John Rumpler, General Manager/Director, QBE Trade Indemnity Australia Ltd, Warren Scott, Coudert Brothers, and Michelle Silvers, one of the originators of creditors recovery service insurance, who variously either provided documents or discussed with the author some of the issues raised in this article. The author of course accepts full responsibility for any errors that appear.

1 This article does not deal with insolvency of natural persons.

2 For example, Co-Operatives Act 1992 (NSW), Co-Operatives Act 1997 (SA).

shares and, of course, ordinary ongoing cash flow.[3] Also timing adjustments that are available to the corporation both in respect of accounts receivable and accounts payable are to be taken into account.[4]

Not all company directors appreciate exactly what insolvency is, although the law requires them to be able to understand the affairs of each company on whose board they sit and to reach a reasonably informed opinion of the company's financial capacity.[5] This has considerable implications for the insurance of insolvency risk.

When an insurer takes on insolvency risk, the insurer will need to price according to the level of knowledge of the directors of the corporation that purchases the insurance. Sophisticated questioning techniques are beginning to be developed by most insurers to enable accurate pricing decisions to be made.

Insolvency risk is a category of credit risk

Historically, it was bankers and not insurers that took on insolvency risk from the business community. As the borders between the banking and insurance communities blur, the techniques for covering insolvency risk are developing anew.

Bankers routinely talk about credit risk. Credit risk is the risk of not being paid a debt. An important category of credit risk is insolvency risk. Insolvency risk can be understood as the risk of not being paid as a result of insolvency. The concepts and necessary analysis remain more familiar to bankers than insurers in Australia, although as financial products and their providers begin to compete more actively with each other outside traditional boundaries, the distinction may become less relevant.

Protecting company directors

D&O covers usually insure against insolvency risk

Directors can become personally liable for the debts of a corporation when the corporation trades while insolvent.[6] And if one director is liable for insolvent trading, it is likely that all will be, unless any of them are able to rely on the defences provided by s 588H of the Corporations Law. In most cases, they will have the same information before them in their capacities as members of a board of directors.[7]

A company director who faces the prospect of being made liable for insolvent trading will want to know if the law permits D&O insurance to

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3 *Standard Chartered Bank of Australia Ltd v Antico* (1995) 13 ALR 1; 18 ACSR 1 at 71 per Hodgson J.

4 *Metropolitan Fire Systems Pty Ltd v Miller & Ewins* (1997) 23 ACSR 699 at 702 per Einfeld J.

5 Id, at 74-5. See, Mescher, "Company Directors' Knowledge of the Insolvent Trading Provisions" (1998) 6 *Insolvency LJ* 171.

6 Association liability insurance by comparison protects members of an association's board of management when they fail to fulfil their duties.

7 *Hawcroft General Trading Co Ltd v Edgar and Winters* (1996) 20 ACSR 541 at 548 per Tamberlin J.

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respond to this risk. The key Corporations Law provision relating to insurance for directors is s 241. Pursuant to s 241(2) the D&O insurance can respond if the liability does not arise out of conduct involving a lack of good faith.

How does director liability for insolvent trading arise?

In Australia, the conventional wisdom is that directors are in breach of duty if they cause the company to become insolvent as a result of the declaration or payment of dividends,[8] or to pay directors' fees,[9] or any other debt.

Section 588G requires a director to prevent a company from engaging in insolvent trading. The statutory threshold to be passed before liability can be considered contains four elements as set out in subs (1) as follows:

> [Application of section] This section applies if:
> (a) a person is a director of a company at the time when the company incurs a debt; and
> (b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
> (c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and
> (d) that time is at or after the commencement of this Part.

The key paragraph is para (c). A plaintiff who sues a director must prove that at the time the debt was incurred there existed reasonable grounds for suspicion that the company either was insolvent or would become insolvent by incurring the relevant debt. As to whether reasonable grounds existed, the standard is an objective one.[10]

What defences can directors raise to avoid liability?

Once objective grounds are identified that support a suspicion of insolvency or impending insolvency, the statute passes the burden on to the director. Under s 588H(2) the director needs to defend the claim brought against him or her by proving that:

> at the time when the debt was incurred, the person had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

It is important to recognise that the burden on the plaintiff is now lighter than it used to be. The plaintiff need only prove reasonable grounds for a suspicion and not a basis for an expectation. The plaintiff does not have to show that insolvency is likely; only that it is reasonably possible.[11] However, if that suspicion is demonstrated, the defendant director must show that he or she had reasonable grounds to expect — a likelihood — that the company was solvent and would remain solvent even if it incurred the relevant debt and

8 *QBE Insurance Group Ltd v ASC* (1992) 38 FCR 270; 110 ALR 301; 8 ACSR 631 at 649; 10 ACLC 1490 at 1505-6 per Lockhart J.
9 *Re Washington Diamond Mining Co* [1893] 3 Ch 95 (CA).
10 *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115 at 123-4; *Standard Chartered Bank of Australia Ltd v Antico*, above n 3, 18 ACSR at 74-5.
11 Compare, *Lee Kong v Pilkington (Australia) Ltd* (1997) 25 ACSR 103.

other debts incurred at about the same time. In *Metropolitan Fire Systems Pty Ltd v Miller & Ewins*[12] Einfeld J ruled:

> the defences under s 588H require that there be reasonable grounds to "expect", as opposed to "suspect", solvency as provided in s 588G. From the cases in which the meaning of these words has been considered, it would appear that to "suspect" something requires a lower threshold of knowledge or awareness than to "expect" it: see a discussion on "to suspect" by Kitto J in *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 at 303 [1966] ALR 855; and *3M Australia* at 192. The expectation must be differentiated from mere hope in order to satisfy this defence: *Dunn v Shapowloff* [1978] NSWLR 235; (1978) 3 ACLR 775. It implies a measure of confidence that the company is solvent. The directors must have reasonable grounds for regarding it as likely that the company would at the relevant date have been able to pay its debts as and when they fall due.[13]

Who can sue directors for insolvent trading?

The potential plaintiffs are, in the first instance, a liquidator, and in the second instance, company creditors. It is important to note that insolvency administrators are not included. The law provides an incentive for directors to put a corporation into insolvent administration in appropriate circumstances. By doing so, the directors effectively reduce the risk that an insolvent trading action will be brought against them.[14]

Creditors may, if the liquidator is not doing so, pursue claims against the directors for breach of their s 588G duty not to trade insolvently.[15]

Six months after the winding-up process commences, a creditor can give a liquidator written notice under s 588S stating an intention to begin proceedings under s 588M. The notice will seek the liquidator's permission for the creditor to proceed. There can be three responses.

1. The liquidator gives written consent for the creditor to proceed.

2. If the liquidator does not make a decision within three months after the creditor's notice arrives, the creditor can apply to the court to be able to begin proceedings under s 588T.

3. If the liquidator declines consent and gives reasons why he or she will not consent under s 588T the court must consider them before proceedings commence.

Consequently at a minimum, if a corporation goes into liquidation, the directors bear an exposure to suit by the liquidator or the creditors. Directors and Officers Liability Insurance will respond to the risk, depending upon the wording of the policy. QBE has typical *insuring* clauses. They provide as follows:

> QBE shall pay on behalf of each Insured Person all Loss for which the Insured Person is Not Indemnified by the Corporation, arising from any Claim first made against such Insured Person, individually or otherwise, during the Period of Cover, for damages and which is notified to QBE during the Period of Cover.

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12 Above n 4.
13 Id, 23 ACSR at 711.
14 See, Hertzberg, "Why Are There So Few Insolvent Trading Cases" (1998) 6 *Insolvency LJ* 77.
15 Corporations Law, s 588R.

> QBE shall pay on behalf of the Corporation all Loss for which the Corporation grants indemnification to an Insured Person, as permitted or required by law, arising from any Claim first made again such Insured Person, individually or otherwise during the period of Cover, and which is notified to QBE during the Period of Cover . . .

What are the insurer's interests in relation to insolvent trading?

The first of these two insuring clauses can be taken to protect against that liability, for a director will be an insured person. Consequently, the insurer, under the D&O insurance policy, ought to be concerned to ensure that an insolvency administrator is appointed as soon as there is any reasonable suspicion of possible insolvency. Quite simply it is in the interest of the insurer to avoid liability for insolvent trading becoming the basis of a claim under the policy. However, in the marketplace today, most policies do not contain any specific requirement dealing with this issue. Insurers appear to continue to rely upon the general due diligence obligation of directors. That is a dangerous course for the insurer to take in drafting the policy, although one can understand the reluctance of insurers to be seen as influencing the directors' decision. On that view, which this author does not share, the directors have enough incentive under the law without the need for specific provision in the D&O policy.

For example, placing an insolvent company into administration is attractive for directors who have personally guaranteed company debts. So long as the company is under administration, s 440J prevents creditors from enforcing the guarantee against the directors.

The Australian Taxation Office also provides an incentive for directors to focus on insolvency risk

Also, under the Insolvency (Tax Priorities) Legislation Amendment Act 1993, directors are encouraged to place a company into voluntary administration or even into liquidation when the company is unable to meet tax obligations such as employer group tax obligations.[16] Once the Australian Taxation Office issues a notice under s 222AOE of the Income Tax Assessment Act, directors risk a personal liability for the company's unremitted PAYE obligations. Section 222AOB provides the incentive to put the company into liquidation or to appoint an administrator. Section 222AOB provides in relevant part as follows:

> (1) The persons who are directors of the company from time to time on or after the first deduction day must cause the company to do at least one of the following on or before the due date:
>
> (a) comply . . . in relation to each deduction:
>
> (i) that the company has made . . .; and
>
> (ii) whose due date is the same as the due date;
>
> (b) make an agreement with the Commissioner under section 222ALA in relation to the company's liability under a remittance provision in respect of such deductions;

16 Income Tax Assessment Act, s 222ANA.

(c) appoint an administrator of the company under section 436A of the Corporations Law;
(d) begin to be wound up within the meaning of that Law.

(2) This section is complied with when:

(a) the company complies as mentioned in paragraph (1)(a); or
(b) the company makes an agreement as mentioned in paragraph (1)(b); or
(c) an administrator of the company is appointed under section 436A, 436B or 436C of the Corporations Law; or
(d) the company begins to be wound up within the meaning of that Law;

whichever first happens, even if the directors did not cause the event to happen.

(3) If this section is not complied with on or before the due date, the persons who are directors of the company from time to time after the due date continue to be under the obligation imposed by subsection (1) until this section is complied with.

The position of the ATO is thus quite clear. Pay or go under!

What are the liquidator's duties?

Once a company is in liquidation, a liquidator is duty bound to obtain from the displaced directors a report as to the affairs of the company showing the company's assets and liabilities, the company's creditors and the securities held by them.[17]

The liquidator has a duty to discover not only breaches of companies legislation, but also conduct which falls short of the requisite standards of commercial morality.[18] The liquidator may bring proceedings in the name of the company on its behalf.[19] Where the company is insolvent and has incurred liabilities in the administration of a trust, the report should include the affairs of the trust because there may be liabilities for which the company is personally liable and which are provable against the company.[20] This article does not delve into the added complexities of trustee liability.

Professional indemnity covers sometimes also respond to the risk of insolvency

Civil liability insuring clauses under professional indemnity (PI) policies normally cover professionals acting as directors of a company. If the liability arises during the course of a professional practice, the insurance is likely to respond, although, most policies will not provide cover where a professional adviser is not sued for the giving of negligent advice but is burdened with debts of clients. It is unclear how a PI policy might respond if advisers are sued on the basis that they had become de facto directors. Much would depend upon the wording of the insurance contract, in particular, whether it responded to "breach of professional duty" or to "liability in connection with the business of the Insured".[21]

Under the definition of director in s 60(1)(b) of the Corporations Law a

17 Corporations Law, s 475; *Ganke v CAC* (1990) 19 NSWLR 449; 1 ACSR 764.
18 *Re Allebart Pty Ltd (In liq)* [1971] 1 NSWLR 24 at 26 per Street J.
19 Corporations Law, s 477(2)(a).
20 *Re Indopal Pty Ltd* (1987) 12 ACLR 54; 5 ACLC 278.
21 See eg, *HIH Casualty and General Insurance Ltd v Turner* (unreported, SC(SA), Court of Appeal, June 1999); *GIO of NSW v Penrith City Council* [1999] NSWCA 2 (9 March 1999).

person will be deemed to be a director if they give instructions or directions and the directors of the corporation are accustomed to act in accordance with those instructions or directions. Should a professional adviser go beyond the provisions of what can objectively be characterised as advice and take an active involvement in management, the adviser runs the risk of being deemed to be a director.[22]

Protecting liquidators and insolvency administrators[23]

Cover for liquidators to enable them to pursue recoveries following insolvency

The prospect that directors will be sued for insolvent trading has been increased by the availability of litigation funding products. Historically liquidators and trustees often have had insufficient funds to carry through to conclusion the litigation to recover moneys lost through insolvent trading. This often resulted in inadequate settlements from the liquidator's perspective. Directors facing personal liability had the upper hand in protracted litigation, provided they were well resourced or insured.

Under these new products, the provider of litigation funding, often an insurer, offers to pay some or all of the costs of the liquidator that are incurred in pursuing a debt. In return the funding provider receives a portion of the settlement monies or judgment amount flowing to the liquidator.

Historically the law set aside such arrangements because they were contrary to public policy.[24] No longer. In *Re Movitor Pty Ltd (In liq) v Sims*[25] Drummond J found that a liquidator has a power of sale similar to that which a trustee in bankruptcy has under ss 134(1)(a) and 135(1)(a) of the Bankruptcy Act 1966 (Cth).

In *Movitor* the liquidator wanted to use funds to be provided by an insurer to prosecute an action, pursuant to ss 588M and 588W of the Corporations Law, against former directors of Movitor and Movitor's holding company, Ausind Investments Pty Ltd, for contraventions of the Corporations Law in respect of insolvent trading.

The court held that it was permissible for the liquidator to enter into a contract of litigation insurance with an insurer. His Honour said:

> There is in my opinion no reason for denying to the liquidator exactly the same power as is possessed by a trustee in bankruptcy to dispose of a bare right of action to a stranger whether for a cash payment or on terms that the stranger will pay to the company part of the proceeds of the litigation.[26]

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22 Accord, *Deputy Commissioner of Taxation v Austin* (1998) 28 ACSR 565.
23 See Cini, "Litigation Funding Arrangements in Corporate Insolvency" (1998) 6 *Insolvency LJ* 171; Pascoe, "Dividing the Spoils — Recent Developments in Litigation Funding Insurance" (1998) JBLFP 218.
24 The common law prohibited maintenance and champerty.
25 (1996) 136 ALR 643; 64 FCR 380; 19 ACSR 440; 14 ACLC 587.
26 (1996) 19 ACSR at 448.

More recently, in *Re Tosich Construction Pty Ltd; Ex parte Wily*[27] Lindgren J concluded that the "insurance" was a sale or other disposition of the property of the company and so statutorily sanctioned under s 477(2)(c).

In connection with an earlier form of the insurance, promoted by FAI, Lindgren J observed that:

> FAI and the insured proposed to agree that FAI be paid the premium '"from the resolution sum on resolution" (para 4 of FAI's letter), and that at resolution the insured instruct the Argyle Partnership to distribute the resolution sum in accordance with the insurance agreement (cl 5.1 of the unamended facility document). In my opinion, those provisions did not provide for a sale or other disposition of recoveries. They were a contractual promise by the liquidator to FAI that the liquidator would give a direction to the solicitor. It was not plain to me that what was intended was a sale or other disposition of future property.[28]

As was pointed out in *Bank of Melbourne Ltd v HPM Pty Ltd (In liq)*:[29]

> Section 9 of the Corporations Law, defines "property" in s 477(2)(c) to include a "thing in action". However, unlike s 132 of the Bankruptcy Act, which vests the property of the bankrupt in the trustee upon appointment, the Corporations Law does not vest the property of the company in liquidation in the liquidator unless an order to this effect is made by the court under s 474(2). However, the lack of such an order will not limit a liquidator's power to assign a company's right of action, provided that in such a case, the company remains the "assignor" for the purposes of the transaction: [*Brookfield v Davey Products Pty Ltd* at 307 per Branson J].

Administrators can also utilise creditors recovery funding products

Last year the courts confirmed that not only liquidators can utilise such funding. In *William Felton Co Pty Ltd (Subject To A Deed Of Company Arrangement); Ex Parte Sims*[30] Bryson J extended the availability of such funding arrangements to insolvency administrators. His Honour pointed out that the public policy against maintenance and champerty did not apply because the power to enter into such funding arrangements was a statutory power. Although not a decision in relation to insolvent trading, this case is significant because his Honour characterised the insurance agreement as an equitable assignment of the proceeds of the litigation, when in the future they should be available.

> In any realistic appraisal, the prospects of oppression being worked by litigation brought by someone in charge of the affairs of an insolvent company or of a bankrupt or insolvent person with the aid of outside finance seem to be far less threatening to public policy than the injury done to creditors and other persons interested in the affairs of insolvent companies by inability through lack of resources to pursue claims. The appraisal produces the same result whatever statutory regime insolvency is being managed under.[31]

Pursuant to s 447D of the Corporations Law, the court upheld the agreement

27 (1997) 143 ALR 18; 23 ACSR 126; 15 ACLC 638.
28 (1997) 23 ACSR 126 at 141.
29 (1998) 26 ACSR 110 at 112.
30 (1998) 28 ACSR 228.
31 (1998) 28 ACSR 228 at 236-7.

by correspondence between William Felton & Co Pty Ltd and FAI General Insurance Co Ltd.

Protecting financiers and their customers — taking a risk on someone else's insolvency

Banks take security to protect against insolvency risk

To protect against insolvency risk bankers often take security and carefully scrutinise the cash flow history of a potential borrower and indeed of guarantors for that borrower.

Sometimes asset security, bricks and mortar or a company charge, will not be available.

Credit insurance is a finance product typically supplied by insurers rather than financiers. It is in many respects the oldest form of bancassurance. And it covers insolvency risk.

As an illustration of how it works, consider for example the situation of a hypothetical company whose business is growing rapidly, called Growquik Pty Ltd.

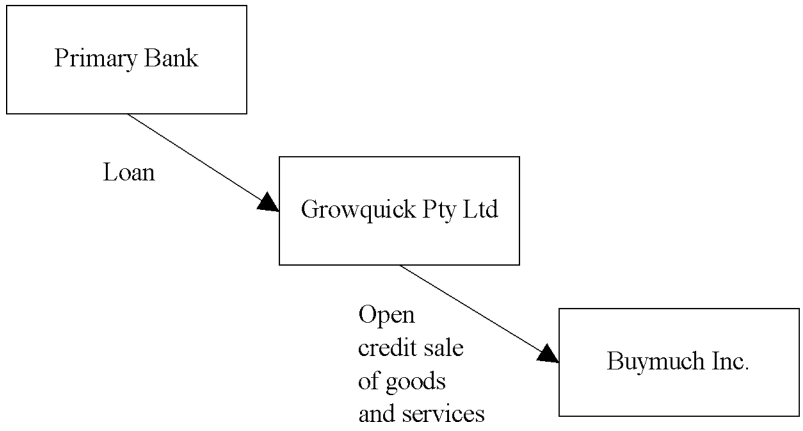
The problem of limited working capital

Growquik has charged all its assets to its primary bank. The company is offered a new project under a lucrative contract, by one of its customers, Buymuch Inc, but it needs additional working capital to be able to fund its performance of that new contract. Growquik goes to its primary bank, and receives a fairly typical response. The primary bank would be delighted to lend more to such a good customer but it requires more security. Unfortunately all Growquik has left to offer is the cash flow from the project.

Consequently, the primary bank will realise — assuming the good record of Growquik — that if it lends Growquik more money, the real risk is on the creditworthiness of the other party to the contract, the purchaser, Buymuch Inc. The primary bank, however, has no relationship with Buymuch.

The situation thus far is depicted in diagram 1.

Diagram 1



One way in which the primary bank can reduce its risk of providing additional working capital without additional asset security being put up is to require that Growquick purchase credit insurance against the risk that Buymuch will not pay.

A very large part of the risk that the purchaser will not pay flows from insolvency risk, that is the risk that Buymuch will become insolvent and therefore become unable to pay.

Checking buyer creditworthiness

Interestingly, far too often the primary bank will not conduct any form of credit check on its customer's purchaser. It knows that the customer has limited resources to conduct a credit check, but as a matter of banking practice in Australia, the primary bank often will leave that task for the customer to do anyway.

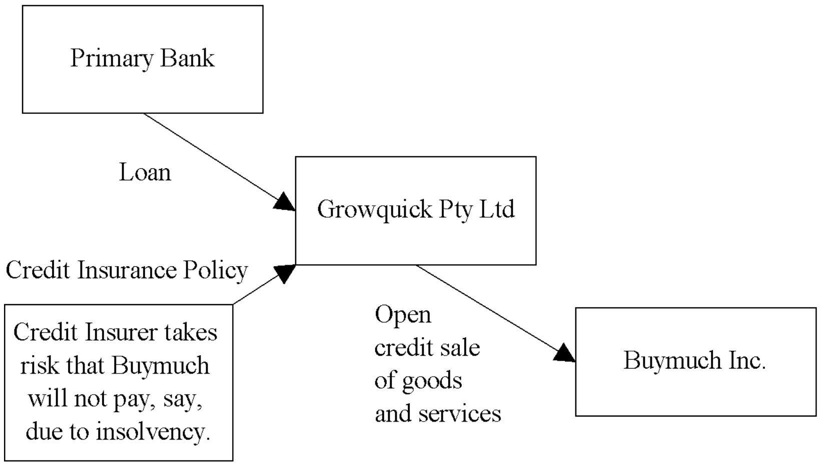
What is credit insurance?

Credit insurance is for the benefit of a creditor — often a seller of goods and services — against certain risks that result in that creditor not being paid. Among those risks is the risk of insolvency of the debtor. According to QBE Trade Indemnity:

> Credit is now a necessity of business and, on average, 40 percent of most business assets are tied up in debtors.

Diagram 2 incorporates the credit insurer into the picture so far.

Diagram 2



The Australian market for credit insurance remains somewhat thin and has been valued at no more than $60m. It is also this author's supposition that the underutilisation of credit insurance in Australia results from inadequate understanding of its utility and value for money.

The premiums on credit insurance policies are generally lower than the cost of factoring or forfeiting receivables, and attract considerably less stamp duty.[32]

Premium rates seem to run between 0.1% and 0.4% of sales value insured. Compared with the cost of transacting business using bank guarantees and letters of credit, or even factoring arrangements, it is reasonable to anticipate some real growth in the utilisation of credit insurance in Australia. Factors purchase the debts outright and have a direct relationship with the purchaser, Buymuch in the example. Growing corporations such as Growquik may not want their customers to be contacted by a factor, or to know that they need the financial support that factors provide. Credit insurers usually only disclose their presence once a claim has been paid and they choose to take recovery action.

Advantages of buying credit insurance

Growquik has decided that it should investigate whether credit insurance makes sense for its business. It begins to think about the problems that it has had for some time in getting paid by some customers. It wonders whether credit insurance — rather expensive in the context of the single new project

32 This article does not detail these differences. As to the law of factoring see: F Salinger, *Factoring Law and Practice*, Sweet & Maxwell, 1991; F Oditak, *Legal Aspects of Receivables Financing*, Sweet & Maxwell, 1991.

— might be worth purchasing. It surmises that a lower premium might be extracted if its entire pool of customers were insured with a credit insurer. It also wants to know:

- Will the primary bank lend more money against the same asset security?
- Will the primary bank lower the cost of borrowing?

Another consideration that crosses the mind of Growquik's managing director is whether there will be any advantage to it in its relationship with its primary bank that would flow from purchasing credit insurance in relation to receivables from all or a large part of its customer base. These policies are called "global", "comprehensive" or " whole turnover" policies. And finally, the managing director realises that the better Growquik's cash flow protection, the lower the risk that default or insolvency at the Buymuch end will thrust Growquik into insolvency.

An investigation of available policy terms

In considering the purchase of credit insurance, a number of legal issues should be considered. When the risk to be insured against is insolvency risk, the most critical legal issues are the definition of insolvency in the policy and the timing and terms of claim payment.

Consider first the definition of insolvency in EFIC's Export Credit Insurance Policy.

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Insolvent	**An entity is insolvent if any of the following happens:** It goes into provisional liquidation or liquidation. It goes into controlled, extraordinary or insolvent administration. It has a custodian, receiver or receiver-manager appointed to all its assets. It becomes bankrupt either voluntarily or involuntarily. It enters into a reorganisation, composition, assignment or arrangement with, or for the benefit of, a majority of or all of its creditors. A moratorium is ordered for a majority of its debts by number or value. Distress, execution, sequestration or another similar process is ordered for its assets. Any event happens that is similar in character and effect to any of these events. It takes irreversible action to achieve, approve or enable any of those events.

Because EFIC insures non-payment and insolvency events that occur overseas, the definition must be broad enough to cover the various definitions of insolvency that can arise under laws of different countries. The last two subparts of the definition produce a very flexible cover. It is also worth noting that forms of insolvent administration constitute an insolvency event under the EFIC policy.

By comparison, under the QBE Trade Indemnity and FAI trade credit policies (which are remarkably similar in their terms) the ability to claim under the policy is triggered later in the insolvency process. Moratorium, insolvent administration and distress actions do not trigger the insolvency cover. This does not mean that there is no cover in place if these events occur. Rather, it means that a claim must be made in relation to non-payment rather than in relation to insolvency.

A review of credit insurance policies in the Australian market today however indicates that very few underwriters utilise the statutory definition of insolvency. Potentially this could give rise to significant and unnecessary disputation, should a corporation become insolvent as a matter of law but not under the applicable insurance policy, or vice versa.

The time it takes for a non-payment claim to be paid generally is considerably longer than the time it takes for an insolvency claim to be paid. For an insolvency claim to be paid under the EFIC policy the waiting period is generally 30 days. By virtue of the definition of a “protracted default” in the QBE policy and the various solvent non-payment events in the EFIC policy, a claim in relation to a solvent non-payment event generally cannot be made until four or six months have elapsed after the due date for payment of the debt.[33] QBE Trade Indemnity’s standard period is four months. EFIC’s is six months. During those months the insured creditor is expected to pursue the debt. One of the reasons that premium rates are relatively low for credit insurance is that insurers depend upon most non-payments being resolved during that debt-chasing-up period, avoiding the need for a claim.

33 All insurers have negotiated the length of that period from time to time.

American Home Assurance Company (AIG) offers an insolvency risk specific cover different again in respect of its flexibility and early payout capacity. The AIG definition of insolvency is triggered when an insolvent administration lasts more than 33 days but unlike QBE Trade Indemnity, it does not have any equivalent to the "irreversible action" part of the EFIC definition.[34]

The selection of 33 days does not correspond to the statutory timing scheme. Section 439A deals with the convening of creditors' meetings. An administrator must call the second creditors meeting to deal with the future of the company within 21 days after the administration begins.[35] Often one extension is allowed under s 439A(6), and AIG clearly has taken the view that 33 days is a reasonable experiential basis in relation to most insolvent administrations.

The AIG definition says:

> G. Insolvent/Insolvency means that any of the following steps, or an equivalent step, has been taken by or against a Buyer under the law of a court having jurisdiction over the Buyer's affairs:
>
> (i) The Buyer has been declared bankrupt;
> (ii) The court approves a compromise, composition or scheme of arrangement between the Buyer and its creditors generally;
> (iii) The Buyer makes a valid assignment, composition or similar arrangement for the benefit of its creditors generally;
> (iv) The court orders the winding-up or liquidation of the Buyer;
> (v) An effective resolution is passed for the voluntary winding-up or liquidation of the Buyer;
> (vi) A receiver, manager, trustee or similar person is appointed to the Buyer.
> (viii) An administrator has been appointed to the Buyer for a period of more than thirty-three days.
>
> The date of Insolvency shall be the date on which the first of the above events occurs.

Claims requirements

The EFIC policy sets out clearly what is required before a claim in relation to insolvency can be made. The following conditions apply.

> 29. Before we can deal with a claim, the following conditions must be met:
> 29.1 You demonstrate to us that:
>
> - the main cause of your loss in your not being paid was one of the events listed in clause 1 [This includes insolvency.]; and
> - you have minimised your loss and you have done your best to overcome any relevant event, in a commercially sensible way.
>
> 29.2 You notified us of the non-payment or relevant event on time.
> 29.3 We have received all declarations to which the claim relates, and those declarations were valid when you sent them to us.
> 29.4 You have paid us all premiums on time.
> 29.5 No person who is to pay you is disputing your right to be paid or disputing how much you are entitled to be paid. This includes the buyer, a guarantor of, or indemnifier for, the buyer's obligations, or any bank that is to pay you.

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34 QBE Trade Indemnity's policy for exports does have the equivalent.
35 Corporations Law, s 439A(5).

29.6 [relates to documentary credits]
29.7 You have not transferred or lost any part of your rights to payment.

These provisions are relatively straightforward and present no surprises to most insureds. Unlike EFIC, AIG specifically requires verification of the amount payable by the person in charge of the insolvency, or where that is not feasible by independent investigation. The term "Qualifying Loss" is used, and in the context of insolvency a loss only qualifies if it is:

(i) Acknowledged as a valid obligation of the Buyer to the Insured by a Receiver, Liquidator or legal equivalent thereof appointed to manage the Insolvent Buyer's affairs or
(ii) Where it is not possible to obtain acknowledgement by the Receiver or Liquidator or its legal equivalent at the time of the claim or at a reasonable time in the future, the amount that is otherwise independently verified (at the Insured's expense) to the reasonable satisfaction of the Company;

At the end of the day, credit insurers only keep business if they pay claims, and the insurers all know that the claim process must also comply with the good faith and timely settlement obligations imposed by the Insurance Contracts Act.

It is important to note here that the private credit insurers are all subject to the Insurance Contracts Act. EFIC, however, has a specific exemption because the risks that it takes are all overseas in location and a large part of its basket of risks consists of risks taken on foreign government entities. The overseas recoveries context for EFIC also is quite different. EFIC does, however, issue a plain English policy so that the insured's rights and obligations are clearly and comprehensively laid out.

The need for an assignment of proceeds of claims under the credit insurance policy

When the primary bank requires that Growquik purchase credit insurance against the risk that Buymuch will not pay, whether as a result of insolvency or not, the primary bank may well expect that a legally binding arrangement will be entered into pursuant to which any claim payment by the credit insurer will flow directly to the primary bank.

The primary bank might also ask for an assignment of the debts payable by Buymuch to Growquik so that any payment by Buymuch will flow directly to the primary bank. As a practical matter, such an arrangement is seldom entered into because if all the early payments under the contract flow to the primary bank, Growquik will have inadequate cash flow to complete the contract. If Growquik has inadequate cash flow, it could become insolvent, and the primary bank will have put at unnecessary risk the entirety of the credit facilities granted to its customer, Growquik.

Another alternative for the primary bank is to seek an assignment of the credit insurance policy. However, credit insurance policies put significant disclosure and performance obligations on the insured. Banks generally do not like to have to perform their customers' obligations and so do not take an assignment of the policy as a whole. Factors on the other hand usually are prepared to assist with the customer's obligations and their ongoing servicing of their customers partly explains the high cost of factoring as compared to credit insurance. Often factors take an interest in the customer's credit insurance policy, with both products providing support for the cash flow of the customer. When that occurs factors generally prefer to be a named insured rather than an assignee.[36] Private credit insurers typically forbid any assignment under the policy terms. An assignment only occurs with the credit insurer's consent. EFIC on the other hand adopts a more permissive approach and incorporates its conditions into s 39 of its policy. It provides as follows:

> It is an essential term of this policy that you are not able to assign *the policy as a whole* to anyone.
>
> *However, with our written permission, you are able to assign to someone else — for example, your bank* — your right to be paid for a claim *under this policy. We will not refuse permission unreasonably*.

The third alternative, and the most popular, is for the primary bank to seek an assignment of the proceeds of claims under the credit insurance policy.

Cash flow lending v asset backed lending

When the primary bank asks its customer for an assignment of proceeds of claims, typically an important discussion is triggered. The customer discloses that it is considering buying credit insurance for its entire portfolio of trade debt. It asks the bank how much more it would lend, at what cost, if the customer purchased the credit insurance?

A bank that is experienced in cash flow lending will react favourably to such a question. In the United States, cash flow lending — not asset-backed — is widespread. It is not yet so widespread in Australia.

In the instance where the primary bank already holds a fixed and floating charge, the incremental value to it of the assignment of proceeds of claims under the credit insurance policy will be indirect only. The bank will lend more not on the face of the assignment, but on the face of the relationship with the customer and the customer's good track record.

An experienced cash flow lender on the other hand will investigate its customer's credit management practices and in particular the analysis of credit risk performed by the customer on those purchasers to whom the customer sells on open credit terms. The better the credit management practices, the larger the working capital facility that will be made available. A critical element in good credit management practice is the sensible and active use of credit insurance.

The insolvency claim

Jumping forward in time with our hypothetical companies, suppose that after making initial payments under the contract, Buymuch fails to make a payment when due under the contract.

A senior manager from Buymuch calls Growquik to indicate that Buymuch is experiencing cash flow difficulties. It becomes clear in the course of discussion that Buymuch is now insolvent.

How soon can Growquik claim? Clause 8(a) of the QBE Trade Indemnity

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36 The position apparently is the same in England. See *Salinger*, above n 32, at 21.

policy allows six months to make a claim. By comparison EFIC allows 12 months, reflecting the longer time frames involved in international trade.

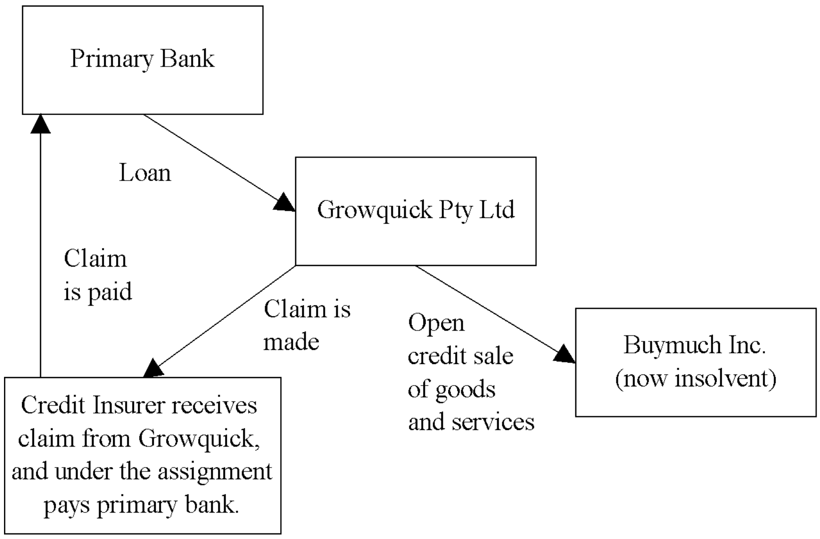
Claim deadlines contained in private credit insurers' policies will be subject to s 54 of the Insurance Contracts Act and effectively may be extended, where this does not cause prejudice to the insurer.

The real question for the insured, Growquik, or its primary bank, is how quickly the claim can be lodged and paid. In an insolvency situation, as opposed to a claim for non-payment or protracted default, there is no reasons in principle why the claim cannot be settled as promptly as whatever adjustment or verification procedures the policy requires. Generally, these will involve no more than confirmation of the insolvency, that the debt is indeed overdue and payable and is not the subject of any genuine dispute.

Depending upon the rules and documentation requirements of the particular credit insurer selected, either Growquik or the bank that has taken the assignment of the proceeds of claims will lodge a claim under the credit insurance policy. The credit insurer will assess the claim, and if everything is in accordance with the policy, an assignment of proceeds will be taken, and the insurer will pay the claim directly to the primary bank.

Diagram 3 demonstrates how the assignment of proceeds of claims fits into the picture as previously drawn in this article.

Diagram 3



What if there are two banks involved?

Consider now the example, quite common in Australia, where the primary bank declines to lend more money to its customer because it is only an asset-backed lender and not a cash flow lender. The customer does not want to allow the lucrative contract to go begging, and approaches another bank. The second bank is unable to convince the primary bank to give it a slice of the fixed and floating charge. The second bank can only take the assignment of the proceeds of claims under the credit insurance policy to provide itself with any comfort at all.

Subject to the rules of law relating to priorities of security interests, which will be addressed briefly later in this article, where the second bank takes that assignment it can not only reduce its risk on insolvency of Buymuch under the new lucrative contract, but it can also effectively reduce its risk on the insolvency on Growquik!. Firstly, the second bank becomes entitled to a claim payment from the credit insurer when Buymuch becomes insolvent. Secondly, if Growquik becomes insolvent and the second bank has taken and perfected its assignment of proceeds of claims under the credit insurance policy, the claim payment will be made to the second bank without being caught up in the Growquik insolvency.

But beware a trap!

When seeking security over the flow of cash from Buymuch to Growquik some banks and financiers fall into a classic trap. They rely upon a document that is titled *Irrevocable Instruction To Pay*, prepared by the credit insurer but issued by the insured to the credit insurer, instructing the credit insurer to pay claims to the bank. If that instruction to pay does not constitute at least an equitable assignment of the contingent debt payable by the credit insurer, then the credit insurer may still have to pay Growquik's insolvency administrator, receiver or liquidator in preference to the bank. The label "*Irrevocable Instruction To Pay*" does not preclude the document from being an equitable assignment if correctly drafted.[37] It is not difficult to draft a valid form of assignment.

The inevitable priorities dispute when more than one bank is involved

If Growquik becomes insolvent, and the credit insurer wants to pay the valid claim in relation to the insolvency of Buymuch, the credit insurer will need to know whom to pay. If it has already received notice of an assignment to a second bank of the debt, the credit insurer may find itself in a quandary. The second bank as assignee from Growquik will want the money paid to it. The insolvency administrator, receiver, liquidator of Growquik will want the same money paid to it, and not to the second bank. Seldom will a valid assignment be disputed if known to the second bank, but as a practical matter the second bank will not know before it advances funds. It is the second bank's claim that is disputed.

If the primary bank has taken both the assignment of the right to be paid under the credit insurance policy and a charge, there will be no priorities dispute. If, however, the primary bank has only a charge "over the whole assets and undertaking" of Growquik, then a question may well arise whether

37 *Cossill v Strangman* [1963] NSWR 1695; *Gee Graphics Pty Ltd v Hartland and Hine Pty Ltd (In liq)* (unreported, SC(NSW) 5133/98, 23 May 1994, BC9402606) at 7.

the chose in action that is Growquik's right to indemnity under the policy constitutes an asset subject to the primary bank's prior charge, thus defeating the assignment to the second bank.

If the second bank has lent against "cash flow security", namely, the assignment of the right to be paid under the credit insurance policy, the second bank will be interested to ensure that its rights to the assigned insurance claim payments take priority over those of, say, the receiver appointed by the primary bank.

The credit insurer will only want to pay the claim in relation to Buymuch's insolvency to one person. Under almost any charge, the act of insolvency will crystallise the floating part of the charge and so the receiver appointed by the primary bank (or any liquidator or administrator) will seek to be paid the claim payment. But the second bank will say that its right under the notified assignment became fixed as a direct right to be paid before the charge crystallised. This argument is not yet finally resolved in the courts.

Legal problems relating to assignment of a contingent debt — the rule in *Dearle v Hall*[38]

Historically, the right to be paid a debt could not be the subject-matter of a security interest. That was because neither the benefit nor the burden of a contractual obligation could be assigned.[39] The conveyancing acts of various states, for example, s 12 of the Conveyancing Act 1919 in New South Wales, permit legal assignments of debts.[40]

At law an assignment must be for the whole of the debt and not merely part of it. The assignment must be absolute and not merely by way of a charge. Notice must be given to the original debtor. To the extent that the debtor had defences against the assignor's rights, the assignee will take subject to those defences.

An equitable assignment can occur even when all the criteria are not met for a legal assignment of the debt. The most important criteria is, of course, the giving of notice. Until notice is given, the debtor is perfectly entitled to pay

38 (1828) 3 Russ 1; 38 ER 475. For a trenchant criticism of the rule, see *Oditah*, above n 32, at 140-2.

39 A Tyree, *Banking Law in Australia*, 3d ed, Butterworths, Sydney, 1998, p 432.

40 Section 12 provides as follows:

12 Assignments of debts and choses in action

Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal chose in action, of which express notice in writing has been given to the debtor, trustee, or other person from whom the assignor would have been entitled to receive or claim such debt or chose in action, shall be, and be deemed to have been effectual in law (subject to all equities which would have been entitled to priority over the right of the assignee if this Act had not passed) to pass and transfer the legal right to such debt or chose in action from the date of such notice, and all legal and other remedies for the same, and the power to give a good discharge for the same without the concurrence of the assignor: Provided always that if the debtor, trustee, or other person liable in respect of such debt or chose in action has had notice that such assignment is disputed by the assignor or anyone claiming under the assignor, or of any other opposing or conflicting claims to such debt or chose in action, the debtor, trustee or other person liable shall be entitled, if he or she thinks fit, to call upon the several persons making claim thereto to interplead concerning the same, or he or she may, if he or she thinks fit, pay the same into court under and in conformity with the provisions of the Acts for the relief of trustees.

the assignor. Once notice is given if the debtor pays the assignor, the assignee can collect the debt regardless, on the basis that the debtor paid the wrong person.[41] Just as importantly, once notice is given the debtor is not to pay any assignee who gives a notice at a later point in time.[42]

When the debt is documented by way of a bill of exchange, the indorsement of the bill will effect the assignment. However, where there is no bill of exchange, and the debt arises by means of an open credit transaction, the law is not quite so simple.

Typically, it is not the first assignee of a debt who takes priority. Rather, priority depends upon which mortgagee, chargee or assignee first gave notice to the debtor that it had acquired a fixed and vested interest in the relevant debt. Of course if the second creditor to take an interest in the debt knew of the interest of the first creditor and raced to give its notice first, the second creditor could not gain priority over the first creditor.[43]

Just to make life difficult for financial institutions the notice can be verbal. Of course verbal notice is harder to prove. The verbal notice must clearly be a notice of the assignment and not a mere casual remark.[44] The real point is: which security interest did the debtor become aware of first?

These priority rules do not apply to volunteers. They only work for creditors who have given something in exchange for the assignment.[45]

Legal problems relating to assignment of a contingent debt — the rule in *Holroyd v Marshall*[46]

There is a view that the right to receive proceeds of claims under a credit insurance policy is a mere expectancy. The rule in *Holroyd v Marshall* deals with the assignment of an expectancy — or future property — for valuable consideration. Under that rule, property immediately vests in the assignee when the assignor acquires the property that was the subject of the assignment. The vesting does not rely on further action by the assignor or the assignee. Consequently any intervening bankruptcy or liquidation of the assignor does not impact the rights of the assignee. In the case of *Re Lind Industrials Finance Syndicate Ltd v Lind*[47] the Court of Appeal considered the case where a bankrupt, Mr Lind, assigned his expectancy in his mother's estate while she remained alive. Mr Lind became bankrupt and was later discharged. After the discharge, he assigned the expectancy again. Then his mother died. The assignments were to different persons and the assignees competed in court. The Court of Appeal unanimously upheld the rights of the

41 *Brice v Bannister* (1878) 3 QBD 569, cited in A Tyree, above n 39, p 434.

42 In Victoria s 84 of the Instruments Act 1958 requires that an assignment of book debts will only be valid at law or in equity once it has been registered. Ordinary open credit will qualify as a book debt.

43 *Warburton v Hill* (1854) Kay 470 at 475; 69 ER 199 at 202; *Re Hamilton's Windsor Ironworks* (1879) 12 Ch D 707 and 711, cited by Edward I Sykes and Sally Walker, *The Law of Securities*, 5th ed, Law Book Co, Sydney, 1993, p 871, n 317.

44 *Re Tichener* (1865) 35 Beav 317; 53 ER 918 , cited by Sykes and Walker, above n 43, p 871, n 319.

45 This article does not address specific lien legislation.

46 (1862) 10 HLC 191; 143 ER 567.

47 [1915] 2 Ch 345.

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earlier assignee as having priority. The court held that the assignee's rights did not rest only in contract. The rights were property rights which survived the bankruptcy and subsequent discharge from bankruptcy.

It is now generally understood that while future book debts can be assigned before the debts actually come into existence, identification of the debt is an essential element toward perfection of the assignment.[48]

In the context of taking an assignment under the proceeds of credit insurance policy claims, the debt only comes into existence once the claim is valid and either due or payable. From an insolvency law perspective, this is a very important issue.

Comfort for the assignee under the assignment of proceeds of claims can be drawn from the case of *Re Androma Pty Ltd*.[49] In that case Androma agreed to grant a mortgage over mining leases. It did so at a point in time when the mining leases had been applied for but had not been granted. The mortgage provided that Androma had to execute the mortgages in registrable form within seven days of the Minister for Mines granting the mining leases. Before the leases were granted Androma was made the subject of a winding-up order. The minister eventually did approve the mining leases, and the mortgagee, under a power of attorney, executed a mortgage in registrable form and registered the mortgage. The liquidator of Androma sought a declaration that the mortgage was a void disposition. Following *Tailby v Offical Receiver*[50] the majority in the Queensland Court of Appeal held that the mortgagee's rights vested immediately the mining leases came to existence. Consequently, they reasoned, no void disposition occurred because the mortgagee's equitable rights were created automatically, and there was nothing Androma could have done to defeat that mortgagee's interest. Androma never had any equitable title in the mining leases that it could dispose of to a third party after it committed its act of insolvency. Alternatively, Androma could not dispose of the mining leases after the act of insolvency because the mining leases automatically became the property of the mortgagee.[51]

When different forms of security interests compete, the problem is rather complex. The holder of a fixed and floating charge will argue that its charge crystallises when an act of insolvency occurs. It will say that when the crystallisation happens, property cannot pass without being subject to the fixed charge. The assignee has constructive notice of the charge. In Australia it is settled that registration of a charge is constructive notice of the existence of the registered charge, but not necessarily of its contents.[52] Ford at [19.390] suggests:

> The legislation does not determine priorities between registrable charges and other unregistrable interests. That matter is left to the general law but under the general

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48 *Palette Shoes Pty Ltd v Krohn* (1937) 58 CLR 1 at 27 per Dixon J.
49 [1987] 2 Qd R 134.
50 (1888) 13 AC 523 per Lord Watson at 533.
51 Accord, *Gee Graphics Pty Ltd v Hartland and Hine Pty Ltd (In liq)*, above n 37, at 8 per Santow J. The author is specially indebted to Arthur Davis, Partner, Middleton Moore & Bevins, who has addressed these issues in a number of practical contexts with him.
52 *Re Dehy Fodders (Aust) Pty Ltd* (1973) 4 SASR 538 at 549.

law the existence of a public register of charges available to inspection by any person may well be relevant when questions of constructive notice arise under general law.[53]

Dr Gough concludes that, on balance, constructive notice ought not to be extended to the notified restrictive clause.[54] In our example, second bank would succeed on the basis of the *Androma* case. As the assignee of a future property right such as a right to proceeds of claims under a credit insurance policy, the second bank will claim that its right vested automatically before the charge became fixed. If that is right, then taking an assignment of a chose-in-action can give the assignee priority over a charge that was created and registered before the assignment was taken.[55]

Wrap-up

The ounce of prevention that credit insurance can provide is an inexpensive way of transferring insolvency risk on open credit transactions. It facilitates finance for small businesses, by creating a cash flow security option, and the legal risks attendant on using credit insurance are manageable provided all the participants appreciate the relevant policy terms and the law relating to assignments of debts and contingent debts. And it reduces a key risk covered by D&O insurance, that is, the risk of insolvent trading; a risk much sharpened by the advent of liquidators' funding products.

53 It is beyond the scope of this article to enter into the still vexed question of competing priorities where restrictive covenants and negative pledges are included in the charge and notified on the ASIC lodgement form.

54 Gough, *Company Charges: An Australian Supplement*, Butterworths, Sydney, 1983, pp 47-8.

55 Sometimes, the purchaser in the position of Buymuch will be unsure that the seller has enough working capital to perform the contract. A purchaser in the position of Buymuch may also want a third party who is certain (as can be) to be solvent to put up a guarantee so that Buymuch will be compensated if Growquik does not perform the contract. Buymuch will insist upon a surety bond being provided by the solvent third party so that if Growquik becomes insolvent or for some other reason does not perform, compensation will be paid to Buymuch. Similar definitional, priorities and claims processing issues arise as in the developed hypothetical above, but their particular problems of application are beyond the scope of this article.

The use of surety bonds is quite common in the construction sector, and in 1998 the start-up of an Australia Surety Association was mooted. Chapman, *Credit Enhancement in a Booming Market*, Phillips Fox, Insurance and Financial Services, 1998, The Year In Review, p 16.