Asia Pacific Guide to Lending and Taking Security - Australia

If things go wrong

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# 1. Please provide a brief description of the insolvency regime. In particular what rights and duties do unsecured and secured lenders have on the insolvency of a debtor? Are there any other matters of concern?

Australia has a number of formal corporate insolvency processes, as set out below:

Voluntary administration

A deed of company arrangement

Restructuring and a restructuring plan

Provisional liquidation

Liquidation/winding up

Receivership

A scheme of arrangement

These processes may operate sequentially, concurrently or as alternatives.

**Voluntary administration**

The voluntary administration regime in the Corporations Act is the most widely used formal corporate insolvency mechanism. A voluntary administration may be commenced by any of the following:

The directors of a company resolve that, in their opinion, the company is, or is likely to become, insolvent and that an administrator should be appointed.

A liquidator or provisional liquidator if they think that the company is insolvent or likely to become insolvent.

A secured creditor is entitled to enforce a security interest over the whole or substantially the whole of the company's assets.

Administrators' fees and expenses and employee entitlements ordinarily take priority over assets subject to a circulating security interest in external administration.

The administrator's right of indemnity out of the property of the company (for debts or liabilities incurred by the administrator and for the administrator's remuneration) takes priority over:

Unsecured debts of the company; and

Any debts secured by any circulating security interest (such as cash, receivables and inventory).

The administration usually ends after creditors resolve at the second meeting of creditors to:

End the administration and return control of the company back to its directors.

Enter into a deed of company arrangement if one has been proposed; or

Have the company wound up.

Therefore, the voluntary administration process is very much creditor controlled.

**Deed of company arrangement**

A deed of company arrangement (DOCA) is a very flexible restructuring agreement between a company and its creditors. The terms of a DOCA are, in essence, limited only by the imagination of the draftsperson, and may allow the debtor company to:

Trade on, whether under the control of its directors, deed administrators or receivers appointed by a secured creditor; or

Provide for the sale of assets, for the sale or issue of equity or for creditors' claims to be transferred to a creditors' trust or another entity in a corporate group.

A DOCA will provide for the contribution to a fund for the distribution of dividends to creditors in return for a release of creditors' claims against the company.

A DOCA must give employee entitlements, such as wages, statutory priority to which the employees would be entitled in a winding up out of assets of the company, unless the employee creditors vote to modify this priority.

Significantly, a DOCA may bind secured creditors of a debtor company, even if they vote against or abstain from voting on the resolution to enter into the DOCA, but a DOCA leaves secured creditors free to deal with their security outside the DOCA.

Restructuring - restructuring plan

The new process of "restructuring" was introduced to the Corporations Act from the start of 2021.

The process has many similarities to voluntary administration, but unlike that process, it is a debtor-in-possession regime. The process is initiated by the directors, who appoint a restructuring practitioner to have oversight of the restructuring. To be eligible, companies must have liabilities of less than AUD 1 million (including contingent and future liabilities) and must not have used the process within the preceding seven years.

Like an administration, the restructuring practitioner's fees and expenses ordinarily take priority over assets subject to a circulating security interest.

The restructuring practitioner's right of indemnity out of the property of the company (for debts or liabilities incurred by the restructuring practitioner and for the restructuring practitioner's remuneration) takes priority over the:

Unsecured debts of the company; and

Any debts secured by any circulating security interest (such as cash, receivables and inventory).

The company develops a restructuring plan that is put to creditors. The "restructuring" phase will ordinarily end following a vote by creditors about this plan. The vote takes place without a formal meeting. There are two possible outcomes of the vote: either the restructuring plan is adopted (in which case it will become binding) or it is rejected by the creditors.

The intent of the restructuring plan is to create a fund that is used to pay creditors in return for compromising their claims against the company. The restructuring plan:

Will identify what property of the company will be dealt with under the plan and its anticipated value, how it will be dealt with and, if sales are proposed, how they will take place; and

Must provide that all admissible debts and claims rank equally.

As the restructuring plan cannot be proposed unless all outstanding employee entitlements have been paid, and as future employee entitlements are excluded from its operation, employee entitlements are given no specific priority in the plan itself.

A secured creditor is only bound by the restructuring plan:

To the extent that the value of the assets that are the subject of its security is less than its debt (and then to the extent of its unsecured claim); and

Otherwise, only to the extent that the secured creditor consents to be bound by the plan.

**Provisional liquidation**

The Federal Court of Australia or the Supreme Courts of the states and territories of Australia may appoint a provisional liquidator to the company. The court may appoint a provisional liquidator if a valid winding up application has been made and it is reasonably likely that a winding up order will be made. A provisional liquidator's primary duty is to preserve the status quo to ensure the least possible harm to all parties and to enable the court to decide, after further examination, whether the company should be wound up.

**Winding up**

A winding up (or liquidation) on insolvency is a terminal procedure intended to realize a company's assets and distribute the assets among its creditors.

A court-ordered or compulsory winding up can only be effected by an order of the Federal Court of Australia or the Supreme Courts of the states and territories of Australia.

A creditors' voluntary winding up usually commences either:

Pursuant to a special resolution of the company's members in circumstances where there is no declaration of solvency made by the directors of the company; and

By resolution of creditors at a second meeting of creditors of a company in voluntary administration.

In a winding up, all unsecured creditors with debts or claims against the company are entitled to participate in seeking payment of a dividend from the available assets if the circumstances giving rise to their debt or claim arose before the "relevant date." The relevant date is usually the date on which the winding up order was made or the date of the appointment of the administrator in a preceding voluntary administration.

Claims are submitted to the liquidator pursuant to a statutory proof of debt procedure.

Secured creditors are generally entitled to enforce their security interest during the liquidation. However, a secured creditor's claim to assets subject to a circulating security interest (usually cash, receivables, inventory and similar assets) may be subordinated to specified employee claims such as wages, superannuation, and leave and redundancy entitlements, where the property of the company is insufficient to meet payment of those employee claims.

The following specified priority debts and claims will take priority over the claims of unsecured creditors:

Expenses incurred by an administrator or liquidator to preserve and realize the property of the company.

The costs and expenses of obtaining any order for liquidation.

Priority employee entitlements.

**Receivership**

A secured creditor may appoint its own receiver "over the top" of the administrator — generally, provided it does so within 13 business days of the appointment of the administrator. The court may also appoint a receiver in exceptional circumstances. If the secured creditor appoints a receiver, the receiver assumes effective control of some or all of the company's assets (depending on the terms of the charge or security) with a view to realizing enough of the charged assets to repay the debt owed to the secured creditor. Concurrent receiverships and administrations are common.

While secured creditors are subject to a moratorium, the administrator is not at liberty to deal with the assets that are the subject of secured creditors' rights without the secured creditors' consent, leave of the court or unless it is in the ordinary course of business.

A receiver has no direct role in relation to the unsecured creditors of the company.

**Schemes of arrangement**

A scheme of arrangement is a mechanism that may be used by a solvent or insolvent company to reach an agreement or compromise with its creditors or members, or both. Schemes of arrangement are, however, less commonly used as a restructuring process, due to the time and cost associated with their implementation.

# 2. Is it possible to obtain a moratorium before insolvency?

As a general proposition, no. Australia has introduced a "safe harbor" regime that protects directors from personal liability for insolvent trading. The regime does not provide any moratorium for claims against the company itself.

A discussion of the moratoria that arise after the commencement of formal insolvency processes is set out below.

Voluntary administration

The voluntary administration procedure imposes a statutory moratorium in respect of claims and proceedings against the company during the period of the voluntary administration.

Subject to a few limited exceptions, unless consent of the administrator or the court is first obtained, the following will apply during the period of the voluntary administration:

Creditors will be prohibited from taking any action against the company to recover debts, enforce security interests or have the company wound up.

Owners or lessors of property that is being used by the company (including landlords and retention of title suppliers) will be prohibited from seizing or reclaiming their property.

There is also a general prohibition on the transfer of shares of a company in administration and a moratorium on the enforcement of guarantees given by directors, their spouses or relatives.

The statutory moratoria ceases once the company proceeds to liquidation or a DOCA, although other moratorium provisions will then apply.

Receivership

There is no moratorium or stay in relation to the enforcement of claims against a debtor company where it is only in receivership. However, where a receivership is concurrent with an administration, the receiver will effectively have the benefit of the statutory moratorium applicable in the administration.

Deed of company arrangement

The Corporations Act specifies certain minimum requirements of a DOCA, including the nature and duration of any moratorium period.

**Restructuring - restructuring plan**

The restructuring process attracts similar moratoria for claims against the company as the voluntary administration process.

Creditors bound by the restructuring plan cannot apply or proceed with an application to wind up the company or begin or proceed with court proceedings or enforcement of court orders, where to do so would rely on a debt compromised by the plan.

Winding up

In a winding up, there is a statutory stay of proceedings against the company and a prohibition on enforcement (by unsecured creditors) against the property of the company other than with the consent of the liquidator or leave of the court. Unsecured claims against the company should generally be pursued under the proof of debt procedure.

Dealings with the property of the company after a winding up other than by the liquidator are void.

**Prohibition on use of *ipso facto* clauses**

There is a statutory moratorium on the enforcement of ipso facto clauses in pre-insolvency contracts entered into on and from 1 July 2018 to enable the proper facilitation of some of the insolvency processes identified above. This stay does not apply to variations to or novations of contracts where the original contract was entered into prior to 1 July 2018, but only where such variation or novation is made before 1 July 2023. From 1 July 2023, these carve-outs for varied or novated contracts will cease to apply.

An ipso facto clause is a clause in a contract that permits the other contracting party to either terminate or modify the operation of the contract due to an insolvency event occurring.

A contracting party is restricted from enforcing such a right while the insolvent party is undergoing a voluntary administration process, a restructuring, a receivership over all or substantially all the assets of the company, or a scheme of arrangement undertaken by reason of the company's insolvency. Therefore, the other contracting party will not be entitled to rely on the ipso facto clause to terminate the contract or modify or accelerate any payments under the terms of the contract in reliance on the insolvency event.

Importantly for lenders, there are various exclusions to the operation of the restriction. A significant exclusion is for lenders in respect of rights to enforce security agreements with obligors (but note the discussion below in question 4, dealing further with the enforcement of security agreements in a formal insolvency context). There are numerous other exemptions to the stay. In the event that a restriction imposed on the enforcement of an ipso facto clause is relevant to you, we recommend that you take specific advice in relation to those exemptions relevant to your circumstances.

# 3. When a company is the subject of a formal insolvency procedure, can the company’s pre-insolvency transactions be set aside?

Yes, in certain circumstances. There is a range of actions that become available to a liquidator when a company is wound up, which can involve challenges to pre-insolvency transactions.

Liquidators have broad powers to investigate the affairs of the company, including compulsory powers to compel the assistance of directors and officers as well as the production of books and records and to require the attendance of persons before a court to face examination.

Liquidators may also have various causes of action available to them to recover assets or undo certain transactions, including recovering preferential payments, unwinding uncommercial transactions and setting aside unfair loans and unreasonable director-related transactions. Financing transactions are not immune from those causes of action as set out below.

Unfair preferences

A liquidator may recover, as an unfair preference, payments made to, or benefits received by, a creditor of the company in respect of an unsecured debt owed by the company within a period of six months prior to the deemed commencement of the winding-up, if:

That unsecured creditor was preferred over other unsecured creditors; and

The payment or benefit was received at a time when the company was insolvent or the company became insolvent as a result of making that payment or giving that benefit.

There are various defenses to an unfair preference claim, including that the payment(s) were received in good faith or that a "running account" existed between the creditor and the debtor.

A grant of security for a previously unsecured debt may constitute an unfair preference that can be avoided by a liquidator under this cause of action.

Rights to recover unfair preferences may be more restricted where the company has undergone a liquidation using the simplified liquidation regime. Such a regime is only available for companies with liabilities of less than AUD 1 million.

Uncommercial transactions

An uncommercial transaction of the company entered into within two years prior to the deemed commencement of the liquidation is voidable on the application of the liquidator if it was entered into, or given effect to, at a time when the company was insolvent or if the company became insolvent as a result of it entering into the transaction.

Whether a transaction is "uncommercial" is assessed by reference to, among other factors, the benefits and detriment to the company and to other parties entering into the transaction. There are various defenses to an uncommercial transaction claim.

Certain financing transactions may be capable of being attacked as uncommercial transactions, for example, the granting of security for previously unsecured debts or the granting of guarantees for the indebtedness of third parties.

# 4. When can a lender enforce its security? Can security be enforced out of court following an event of default (or other contractual trigger event), or is a court order required? Are there any restrictions that apply before a lender may enforce its security?

As a general proposition, a secured lender will be free to enforce its security at any time following an event of default by a debtor on the terms of the relevant security instrument and without a court order. However, a secured lender may need to obtain a court order permitting the enforcement of its security where, for example, there is some defect or ambiguity in the security instrument. In relation to security over real estate and certain other types of assets, various notice requirements may also apply before enforcement action may be taken (or a sale of the secured property effected).

The other restriction is that if a voluntary administrator is appointed to a debtor or a restructuring is commenced, then the secured lender, if it has security over the whole, or substantially the whole, of the property of the debtor, has 13 business days from the appointment of the voluntary administrator or the commencement of a restructuring to elect to appoint a receiver.

Depending on the nature of the security, for example, if the security is a possessory security interest, further restrictions on enforcement rights during an administration or restructuring may apply.

# 5. Do any limitation periods apply in relation to bringing an action to enforce security?

Yes. However, as Australia is a federation of states and territories, each of which may have its own peculiar laws concerning the limitation of actions for suing on securities and in respect of interests in land, the relevant time limits will turn on the facts. Expert assistance should be sought in relation to particular enforcement scenarios.

# 6. Is there any particular way in which secured assets must be liquidated on enforcement (e.g., by auction or court sale)?

No, but as a general proposition, mortgagees and receivers are under a duty, when exercising a power of sale of secured property, to take all reasonable care to obtain either of the following:

Not less than market value for the property if, when it is sold, it has a market value; or

The best price reasonably obtainable if it does not have a market value.

To best protect themselves from liability, mortgagees and receivers will typically obtain independent valuations of secured assets prior to attempting to sell those assets and will then often engage in a public sale process or campaign to generate interest in the asset, for example, by public auction, tender or expressions of interest.

# 7. Are there any particular legal or practical difficulties or delays in enforcing security?

Where the relevant security instruments are immediately enforceable in accordance with their terms, the enforcement and sale of the security property can be straightforward and completed relatively quickly.

However, that process can be complicated or delayed in any number of ways where third parties seek to intervene, for example, where competing interests are claimed in land or where a challenge to the relevant power of sale is commenced.

The possibility of a voluntary administration or restructuring moratorium (discussed in the answer to question 2 of this section) must also be kept in mind.

# 8. In relation to enforcement, are there any specific requirements to be borne in mind if the lender is a foreign entity?

Issues may arise for a foreign entity that is the mortgagee of land and wishes to acquire the relevant secured property (if it is real property) (rather than exercising a power of sale to a third party) in the event of a default by the mortgagor. In that case, the mortgagee may first need to obtain approval from the FIRB before completing the acquisition. Similar considerations may also apply if the security is over shares in an Australian listed company.

For more information regarding the enforcement of security by a foreign entity, please see the answer to question 1 of the "When considering whether to lend" section.

Separately, the insolvency process may be complicated if a debtor company has assets in multiple jurisdictions or where there are concurrent foreign and local proceedings regarding the debtor company. However, the UNCITRAL Model Law on Cross Border Insolvency has been adopted in Australia in the Cross-Border Insolvency Act 2008 (Cth), which may be invoked by the application for "recognition of a foreign proceeding." The process that flows is designed to facilitate multijurisdictional insolvencies and can be a useful tool in these scenarios.

# 9. Is there any reason why you think that arbitration rather than litigation might be advantageous in resolving disputes under the finance documents, and if so, why? Please outline the relative merits of arbitration and litigation, including the ease of enforcement of foreign judgments and foreign awards from different jurisdictions. Is it possible to rely on a hybrid enforcement provision that allows the lenders to opt for either arbitration or litigation as they see fit?

The key advantage of arbitration is the availability of arbitral awards being enforced in over 150 countries that are parties to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. This means that an award made in one state that is party to the New York Convention can be enforced by the courts of any other state party (e.g., where the award debtor has assets) as a judgment of the court. There are limited grounds (relating to procedural issues and public policy) on which a court can refuse to enforce an award.

Foreign judgments can generally be enforced in countries and from countries where reciprocal arrangements have been established if there are no reciprocal arrangements, parties seeking to enforce a foreign judgment in Australia will need to rely on common law principles.

Other advantages of arbitration include that an award is final and binding and cannot be appealed. It can only be challenged on limited procedural grounds or public policy. Litigation generally permits appeals (either by right or by leave) that may involve one or more layers of appeal and involve additional time, cost and complexity. However, the right to appeal in litigation may also be considered an advantage, depending on the circumstances of the case.

In addition, arbitration proceedings in most places (including Australia) are confidential unless the parties expressly agree otherwise. Litigation is generally conducted in public, with the decision also being made available to the public.

Other advantages of litigation include the certainty of the procedure of the courts and costs and efficiency. Compared with other jurisdictions, Australian courts are known to finalize matters promptly and efficiently. The courts also have the power to join additional parties to proceedings (provided they are subject to the court's jurisdiction). With arbitration, the powers of the tribunal are more limited to those powers given by the parties in the arbitration agreement or by the arbitral rules or the law that applies. For example, they cannot join parties unless the parties have consented to arbitration.

A hybrid enforcement clause that allows for the election by one party to pursue claims through litigation or arbitration is enforceable in Australia.

# 10. Are asymmetrical jurisdiction clauses enforceable? (By this we mean clauses that allow the lenders, but not the borrowers, to make certain choices in relation to choice of jurisdiction and how to litigate. These types of clauses allow the lenders, but not the borrowers, to commence proceedings in any court they choose, but restrict the borrowers to commencing proceedings in one jurisdiction only. This may also allow the lenders, but not the borrowers, to choose whether to litigate the finance documents before a court or to submit to arbitration in relation to them, but restrict the borrowers to either litigation or arbitration, as specified in the agreement).

It is common for an option clause (where one party may choose arbitration over litigation or vice versa) to be included in finance documents. These clauses have not yet been tested in the Australian courts but they have been enforced by the English courts. The definition of an "arbitration agreement" under the International Arbitration Act 1974 (Cth) would appear to be broad enough to cover these option clauses. There is nothing in the Act or the general law that would prevent a party from agreeing to this type of option clause.

Asymmetrical jurisdiction clauses that purport to restrict the right of one party to commence proceedings in one jurisdiction but permit the other party to commence proceedings in any jurisdiction have not been considered in the Australian courts. It is likely that, if faced with this type of clause, an Australian court would resolve the issue of whether it had jurisdiction by reference to the common law principle of forum non conveniens.

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