

MW Forensic is a newsletter prepared on an ad hoc basis covering topical issues in the areas of business valuations and forensic accounting.

Treatment of family trusts in family law property disputes

The Family Court can make orders altering the property interest of the marital parties under s. 79 of the *Family Law Act 1975 (Cth)*.

As stated in *In the Marriage of Goodwin* (1990) 101 FLR 386 at 392: “*The question whether the property of the trust is, in reality, the property of the parties or one of them ... is a matter dependent upon the facts and circumstances of each particular case including the terms of the relevant trust deed*”.

In the Marriage of Ashton [1986] Fam CA 20 a husband who had been the trustee of a family trust replaced himself as trustee with a company but continued as sole appointor. He was not a beneficiary but received income from the trust. It was conceded that he was “in full control of the assets of the trust”. The evidence made clear that he applied the assets and income from them as he wished and for his own benefit. The Full Court held that “No person other than the husband has any real interest in the property or income of the trust except at the will of the husband”. Special leave to appeal from that decision was refused by the High Court on 5 December 1986 (Gibbs CJ, Wilson and Brennan JJ).

A recent High Court case *Kennon v Spry* [2008] HCA 56 involved a family trust.

It was held that where a family trust includes “spouses” as a class of beneficiary, the court can chose to include the former wife within this class despite court orders meaning she is no longer technically a spouse.

The 4-1 majority decision also found that even where there are several beneficiaries besides the husband and wife, the assets of the trust could be treated as property of the marriage where the wife was a beneficiary and the husband the trustee with the power to distribute all the trust’s assets to the wife.

Key issues were that:

- The husband had legal title to the trust
- The husband had absolute power to appoint the whole of the fund to his wife at his discretion
- The wife had equitable rights of due consideration in the trust.

Impact of Global Economic Downturn on SME Business Valuations

The Global economic downturn is having a direct impact in Australia.

World financial markets have come under severe stress since September 2008 when turmoil arose from the failure of several financial institutions in the USA and Europe.

This has led to a serious tightening in global credit availability.

Market prices on the Australian Stock Exchange have fallen dramatically – to a 6 year low.

World growth has dramatically slowed; with Australia having –0.5% growth in the December 2008 quarter.

How has this affected the value of Small to Medium Enterprises in Australia?

Business are worth their future net cash flows discounted at an appropriate rate to reflect the risk free rate of return plus associated risk.

Theoretically a discounted cash flow analysis is the best method of valuation.

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Water Wheel Case – sets out a checklist of Insolvency Indicators

In 2003 MW Forensic discussed the judgement in ASIC v Plymin, Elliott & Harrison [2003] VSC 123 (5 May 2003), known as **the “Water Wheel case” which highlighted the responsibilities of directors to prevent insolvent trading.**

In light of recent decline in economic conditions we consider it appropriate to revisit this case.

This was a civil penalty proceeding brought by the Australian Securities and Investments Commission (“ASIC”), against three company directors in relation to alleged insolvent trading by two companies, Water Wheel Mills Pty Ltd and Water Wheel Holdings Limited.

At all relevant times the defendant Plymin was the Managing Director, the defendant Harrison was the Chairman of the Board of Directors and the defendant Elliott was a non-executive director of the companies

This case involved ASIC issuing proceedings for breach of Section 588G of the Corporations Act 2001 (Cth) regarding a director’s duty to prevent insolvent trading by the company.

Section 588J (1) provides:

“Where, on an application for a civil penalty order against a person in relation to a contravention of Section 588G, the Court is satisfied that:

- (a) the person committed the contravention in relation to the incurring of a debt by a company; and
- (b) the debt is wholly or partly unsecured; and
- (c) the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the company’s insolvency;

the Court may (whether or not it makes an order under subsection 1317EA(3)) order the first-mentioned person to pay to the company compensation equal to the amount of that loss or damage.”

There was no debate between the parties about the relevant legal tests of insolvency.

Section 9 of the Corporations Law provides that “insolvent” has the meaning given by s.95A (2) of the Law which stated that a person who is not solvent is insolvent. In turn, s.95A (1) of the Law provided that 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. **This is the so-called “cash flow test” of insolvency:**

“The cash flow test provides that a company is insolvent when it is unable to pay its debts as they fall due. It is of no consequence, under this test, that assets exceed liabilities. The important point is: can the company pay its way in carrying on its business? The court, in examining whether a company is suffering cash flow insolvency, will consider whether the company is actually paying its debtors.

A checklist of matters was put to the second defendant’s expert witness as being indicators of insolvency, was a fairly extensive list, albeit in general terms, and brought to mind very common features in insolvency situations.

The list was paraphrased as follows:

1. Continuing losses.
2. Liquidity ratios below 1:3.
3. Overdue Commonwealth and State taxes.
4. Poor relationship with present bank, including inability to borrow further funds.
5. No access to alternative finance.
6. Inability to raise further equity capital.
7. Suppliers placing [company] on COD, or otherwise demanding special payments before resuming supply.
8. Creditors unpaid outside trading terms.
9. Issuing of post-dated cheques.
10. Dishonoured cheques.
11. Special arrangements with selected creditors.
12. Solicitors’ letters, summons[es], judgments or warrants issued against the company.

13. Payments to creditors of rounded sums which are not reconcilable to specific invoices.
14. Inability to produce timely and accurate financial information to display the company's trading performance and financial position, and make reliable forecasts."

The evidence showed that most of these indicators were present in the case of Water Wheel. **The Court determined the date of insolvency was the date on which the Water Wheel's banker reclassified its loan as "payable on demand."**

In considering the issue of when a debt is due and payable the Court referred to:

- *Manpac Industries Pty Ltd v Ceccattini* [2002 NSWSC 330, where Young CJ indicated that, in business, payments are not always made within trading terms written on the invoice and therefore "it is relevant to take into consideration the relationships between creditor and debtor, any agreement and the course of conduct"
- *Lee Kong v Pilkington (Aust) Ltd* (1997) 25 ACSR 103, a decision of the Full Court of the

Supreme Court of Western Australia where Owen J commented that "*the mere fact that a creditor refrains from taking enforcement action (whether by suing for the debt, seeking to bankrupt or wind up the debtor, or seeking to enforce any security) does not negative the debt being "due" for the purposes of the provision.*"

The Court did not comment on the apparent conflict of these cases.

In regard to the issue of when a debt is incurred [date of contract, date of order or date of delivery], the Court adopted what was said by Hodgson J in *Leigh-Mardon Pty Ltd v Wawn* (1995) 17 ACSR 741: "... In relation to sale of goods, it seems to me that, in some cases, **it will be the order which in substance and commercial reality renders the company liable** for the price of the goods, even if that price is not actually payable until delivery; while in other cases, it will be the acceptance of delivery which, as a matter of substance and commercial reality, so renders the company liable. And intermediate positions are possible...."

Impact of Global Economic Downturn on SME Business Valuations

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However, due to lack of information about future cash flows, typically most established SMEs are valued on a capitalisation of earnings approach.

This involves capitalisation of estimated future maintainable earnings at a rate that reflects returns generally available and the risk of achieving those earnings.

A potential owner is buying future earnings, not past earnings. Therefore there is a high degree of uncertainty.

Most business do not have budgets and therefore the valuer is focusing mainly on recent past trading to assess the maintainable earnings of the business.

Some business are more cyclical than others (eg; building, construction, hospitality, tourism, high-end retail).

In times of economic uncertainty such businesses are unlikely to achieve earnings similar to that of recent years. A significantly higher capitalisation rate would apply to such businesses.

Other non-cyclical business (such as DIY, supermarkets, medical business, aged care facilities) may not require substantial increases in the capitalisation rate.

It is also apparent it is more difficult for buyers to obtain finance to help fund business acquisitions. This also has forced earnings multiples down.

Generally speaking, most businesses will have a lower valuation now than would have applied in recent years, some more so than others.



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We can provide forensic accounting services for a wide variety of dispute related matters from the small to the large.

Further Information

If you would like further information regarding this newsletter or our services, please contact Russell Munday, Bruce Wilkinson, Paul Spence or Gerard Lim at:

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