Australian Government

Insolvency and Trustee Service Australia
New South Wales and
Australian Capital Territory Branch

Impact of Bankruptcy

CREDITOR'S PERSPECTIVE

- Viable option to facilitate payment of a debt owing by a recalcitrant debtor, especially if debtor has interest in jointly owned real estate.
- Steps taken by a creditor to make a debtor bankrupt
- Option of having a private trustee or the Official Trustee, administer the estate.
- Advantages and disadvantages to creditor.
- Using part of the bankruptcy process.
- Closing down an irresponsible debtor in the market place
- Refund of preferential payments

DEBTOR'S PERSPECTIVE

- Advantages and disadvantages.
- Sale of assets, liability to make contributions
- Recovery of property transferred to other persons
- Recovery of preferential payments
- After-acquired property e.g. interest in deceased estate, lottery wins
- Restrictions: operating business, professional membership, company director, trade licenses, overseas travel, access to credit etc
- Impact on relationships :Interaction between Bankruptcy and Family Law (Recent cases)
- Taxation issues: outstanding returns, split returns, refunds, ABNs
- Member of a partnership
- Director/shareholder of company
- Personal guarantees: Insolvent trading
- Release from bankruptcy: discharge and annulment
- Alternatives to Bankruptcy: Informal agreement, Part 1X agreement, Part X Personal Insolvency Agreement.

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Impact of Bankruptcy

CREDITOR'S PERSPECTIVE

From a creditor's perspective, making a non-paying debtor bankrupt (or starting the process) is often a viable option in the debt recovery process and in some cases, the only way of facilitating the payment of a debt owing by a recalcitrant debtor.

Bankruptcy Process

The steps to be taken by a creditor to make a debtor bankrupt are as follows:-

- Obtain judgment against the debtor in either the Local Court (max.$60,0000, District Court (max.$750,000) or Supreme Court (unlimited)
- Issue a Bankruptcy Notice to the debtor via ITSA relying on the unsatisfied judgment. The Bankruptcy Notice must be accompanied by a certificate of judgment issued by the Court where the judgment was obtained. The Notice gives the debtor 21 days from the date of receipt of the Notice, to either pay the debt to the creditor, obtain from the Federal Court of Australia or Federal Magistrates Court, an extension of time in which to comply with the Notice or have the one of the Courts set aside the Notice. (**Note**. Whilst service of the Bankruptcy Notice on the debtor, can be effected by email, post or fax, personal service is recommended to avoid possible disputes with the debtor in subsequent legal proceedings as to whether he or she actually received the Bankruptcy Notice.
- If the debtor fails to take one of the above steps, he or she commits what is known as an *"**act of bankruptcy**",* which is a pre-requisite to taking the next step. (**Note**. There are many other" *acts of bankruptcy"*, however they are rarely used by creditors as a basis for a creditor's petition.)
- The creditor then presents a Creditor's Petition to the Federal Court of Australia or Federal Magistrates Court, based on the above "*act of bankruptcy"* petitioning (requesting) that the Court make a Sequestration Order against the debtor, ie declare the debtor bankrupt. If the creditor wishes to have a registered trustee administer the bankruptcy if and when it occurs instead of the Official Trustee (ITSA), the creditor must obtain the written consent of a registered trustee and attach it to the Creditor's Petition **prior** to

its presentation to the Court. The Court registry enters a hearing date on the Creditor's Petition and the creditor (or their solicitor) arranges **personal** service of the Petition on the debtor.

- The Court hears the Petition and if it is satisfied that debtor has committed an "*act of bankruptcy*" and the debtor is unable to convince the Court that it should dismiss the Petition or grant the debtor an adjournment (eg 14 days in which to pay the debt), the Court will make the Sequestration Order against the debtor. (**Note**. The creditor is not required to establish that the debtor is insolvent; however the debtor when challenging the Petition can argue that they are solvent and accordingly should not be made bankrupt. **Also**, the Court can make the Sequestration Order in the absence of the debtor)
- If the petitioning creditor has previously obtained the consent of a registered trustee that registered trustee is appointed as trustee of the bankrupt estate upon the making of the Sequestration Order against the debtor. If there is no consent of a private trustee, the Official Trustee automatically becomes the trustee. However, creditors by resolution may change the trustee at any time during the administration.

Normally the main consideration in deciding whether to proceed with bankruptcy action against a debtor is the cost factor i.e. given that it will cost at least $3,000 to 5,000.00 in legal expenses to make a debtor bankrupt. Accordingly, the debtor would need to appear to have divisible assets and/or a high level of income, or there is evidence that there are assets that have been disposed of by the debtor that the trustee can recover under the provisions of the Act.

Of course, there are other factors that creditors consider such as:-

- debt write-off for tax purposes.

- to meet the requirements of a debt insurance policy .

- using only part of the bankruptcy process i.e. issuing a Bankruptcy Notice to bring pressure to bear on the debtor to pay the debt.
  In the year ended 30 June 2007, there were 10,981 Bankruptcy Notices issued around Australia, however in the same period the Federal Court and Federal Magistrates Court made only 2,212 Sequestration Orders, which equates to a ratio of approx. 5 Bankruptcy Notices to 1 Sequestration Order. Given that the fee for the issue of a Bankruptcy Notice is only $400.00 and can be prepared by a creditor without too much trouble, it is a relatively

economic way of bringing pressure to bear on a solvent but recalcitrant debtor.

- hostility between creditor and debtor. Often the financial issues between the creditor and debtor become emotional and the creditor decides to pursue the debtor all the way to bankruptcy for reasons other than financial.

- investigations into debtor's affairs. Whilst the debtor may have no apparent assets, the creditor may consider that the debtor's financial affairs require investigation to ascertain whether the debtor has any assets hidden away or has access to financial resources.

- closing down an irresponsible debtor in the market place can be a related consideration.

- ***Advantages***

Therefore, the advantages to a creditor in making a debtor bankrupt include:-

1. Return to Creditors

A dividend to creditors of the bankrupt estate can be generated from:-

- sale of assets;
- income contributions;
- recovery of assets previously disposed of;
- recovery of preference payments;
- after-acquired property e.g. interest in deceased estate, lottery wins etc.

It is also pointed out that bankruptcy is the only practical recovery process where the debtor owns property jointly with another person who is **not a joint debtor** e.g. the matrimonial home is usually jointly owned and if only one of the spouses is liable for the debt, a Writ of Execution/Enforcement by the Sheriff is ineffective. Likewise, if the debtor's real estate is encumbered, the Sheriff is normally reluctant to sell the property as the value of the debtor's net equity in the property can not be ascertained because the bank which holds a mortgage over the property is precluded by the Privacy Act from disclosing the balance owing on the mortgage to the Sheriff. Whereas a trustee has powers under the Bankruptcy Act to obtain such information from the banks and financiers.

At law, joint tenancy is severed upon the bankruptcy of one of the joint owners, and if the non-bankrupt owner refuses to purchase the bankrupt's interest from the trustee or join the trustee in a sale of the property, the trustee can apply to the Federal Court or Federal Magistrates Court under s.30 of the Bankruptcy Act for orders for the sale of the property by the trustee or apply to the Supreme Court for the appointment of receivers for the sale of the property under s.66G of the Conveyancing Act (NSW). Upon the sale of the property, the trustee or receivers will pay the bankrupt's share of the net proceeds into the bankrupt estate. If the non-bankrupt owner is obstructive, the Court may order that trustee's costs and in obtaining the orders and/or the receivers' fees be paid out of their share of the sale proceeds

2. The debtor's affairs are investigated

Investigations may result in the discovery of assets hidden away or transferred to associated parties and/or preferential payments, and/or prosecution action. As mentioned above, bankruptcy can take an irresponsible debtor "*out of the game*".

Even if the investigations do not reveal any of these matters, the creditors can be satisfied that every thing has been done and they can comfortably write-off the debt.

3. Debt write-off for tax and insurance purposes

4. Offer of Composition

After the trustee has conducted investigations and/or the debtor has been bankrupt for 12 to 18 months, the debtor may wish to finalise the bankruptcy and make an offer of composition to creditors with funds given and/or lent to him or her.
Likewise, after issue of a Bankruptcy Notice or the Creditor's Petition, the debtor may seek financial guidance and put forward a proposal for a Debt Agreement under Part IX of the Act or a Personal Insolvency Agreement under Part X, to avoid becoming bankrupt.

Disadvantages

- Additional cost to the debt recovery process;
- Sharing the dividend with debtor's other creditors.
- Possibility of being required to refund to the trustee, a "*preference*" payment received from the debtor **prior** to bankruptcy in the period

starting at the date when the earliest “act of bankruptcy” occurred in the 6 month period before the presentation of the creditor’s petition.

DEBTOR’S PERSPECTIVE

Whilst bankruptcy relieves the debtor of an insurmountable burden of debt, it also imposes certain obligations and restrictions on the person which in some cases can have a serious effect.

Whilst a debtor is released from the majority of their debts such as credit cards, personal loans, overdrafts, goods purchased on credit, taxation debts etc, they are not released from maintenance and child support debts, debts incurred by fraud, fines and penalties imposed by a Court, student Loans and HECs debts.

Furthermore, they will need to pay their accounts for essential services such electricity, gas, water and telephone to maintain the continued supply of those services.

Also, if they do not pay debts such as parking and traffic infringements, fare evasion etc being collected by the State Debt Recovery Office (“SDRO”), they risk having their driver’s licence and/or motor vehicle registration suspended until those debts are paid. If the person requires their driver’s licence for work purposes, the State Debt Recovery Office may restore their driver’s licence upon the person entering into a repayment agreement with the SDRO .

So, bankruptcy does not provide absolution for all of your financial sins.

When a person becomes bankrupt either on their own petition or on the petition of one their creditors, they become subject to various obligations imposed on them by the provisions of the *Bankruptcy Act 1966 (“the Act”)* including the following:

1) Complete and lodge with the Official Receiver, a statement of their affairs providing all their personal details plus details of their assets, liabilities, employment, past and expected future income, assets transferred to other persons in the past 5 years, businesses operated by them by way of sole proprietorship, partnership, company or trust.
2) Provide the trustee of their bankrupt estate with all their financial records and their passport,

3) Attend the trustee whenever the trustee reasonably requires and provide the trustee with information about their financial affairs and employment details,
4) Keeping the trustee notified during the term of their bankruptcy (usually 3 years) of any change in their circumstances eg change of address, change of employment, pay rises, marital status increase/decrease of dependents etc,
5) Attend a meeting of creditors (if convened) and provide information to the trustee and/or creditors as reasonably required,
6) Notify the trustee of any divisible property acquired whilst bankrupt eg. interest in a deceased estate, lottery wins etc
7) If they carry on a business under an assumed name or a trade name they are required to notify every person they deal with that they are an undischarged bankrupt,
8) If they incur a debt in excess of the prescribed amount (currently $4,623.00) they are required to disclose to the credit provider they are an undischarged bankrupt

Prosecution for Offences under the Bankruptcy Act.

If the bankrupt fails to comply with the above obligations imposed on them by the Act they commit an offence for which they may be prosecuted. Penalties upon conviction range from 6 months to 3 years imprisonment

Overseas travel

If a person wishes to travel overseas whilst bankrupt they require the written permission of their trustee to leave Australia. Failure to do so can lead to the person being stopped at the airport or wharf and being prosecuted with the offence of attempting to leave Australia without the written permission of their trustee. Conviction for such an offence carries a maximum prison sentence of 3 years.

If the person is required to pay income contributions they will need to have arrangements in place for any such payments to be made during their absence overseas.

Restrictions on employment, professional membership, office bearers etc

The Act does **not** include any provisions relating to restrictions on the type of employment or profession that a bankrupt can be engaged in. However, there are various statutes, rules and regulations governing employment in various occupations and professions.

The ITSA website has a list of common occupations and the impact of bankruptcy on those occupations. However, as the restrictions and obligations vary widely between organisations and change from time to

time, it is difficult for ITSA to keep abreast of all such obligations and restrictions.
Accordingly**,** debtors contemplating bankruptcy or one of its alternatives are advised to contact their professional association, licensing authority or their employee relations/human resources section for clarification in that regard.

Common examples of restrictions include:

(a) An undischarged bankrupt or a debtor who is currently subject to Part X agreement is precluded by the provisions of the *Corporations Act 2001* from being a director of or involved in the management of a company, and it is an offence under that Act to do so.(**Note**. Debtors who enter a Part IX Debt Agreement with their creditors are **not** so restricted)

(b) An undischarged bankrupt is precluded from holding a trade contractor's license or certificate issued by the NSW Office of Fair Trading ("OFT")

(c) An undischarged bankrupt is precluded from holding a licence or certificate of registration issued by the OFT under the *Property, Stock and Business Agents Act 2002,* **unless** the Commissioner is satisfied the person took all reasonable steps to avoid becoming bankrupt. Furthermore, any person who was in the past 3 years an undischarged bankrupt or had entered into an agreement with their creditors under Part IX or Part X of the Act, is precluded from holding a licence or certificate of registration under the *Property, Stock and Business Agents 2002,* **unless** the Commissioner is satisfied the person took all reasonable steps to avoid becoming bankrupt or entering into the agreement.

(d) Accounting bodies will generally issue a "*Show Cause Notice"* to a member who has become bankrupt or entered into an agreement with their creditors under Part IX or Part X of the Act, calling on the member to show cause as to why the member's practising certificate should not be cancelled. In most cases, if the cause of bankruptcy was unrelated to their duties as an accountant. eg protracted Family Law proceedings, the bankrupt will be allowed to continue practising, possibly with some restrictions. It appears that the Institute of Chartered Accountants takes a somewhat harder line with such matters in comparison to the CPA.

(e) Solicitors are dealt with in a similar manner to accountants; however if allowed to practice, the bankrupt will not be permitted to operate a trust account and generally will need to be an employed solicitor. Furthermore, practicing solicitors are obligated to report the fact to the Law Society if they are served with a bankruptcy notice or a creditor's petition, become bankrupt or enter into an agreement with their creditors under Part IX or Part X of the Act.

(f) Barristers have stricter reporting obligations to the Bar Association which include reporting the fact that the Deputy Commissioner of Taxation has obtained a judgment against them as well as the above obligations on solicitors. If allowed to practice whilst bankrupt, such approval will normally be subject to the bankrupt making proper and regular income contributions to their trustee and fully cooperating with the trustee.

(g) Members of the Police Force and Armed Services are understood to be required to report to their Commanding Officer the fact that they have become bankrupt or entered into an agreement with their creditors under Part IX or Part X of the Act

(h) An undischarged bankrupt is precluded from being a Justice of the Peace and a Member of Parliament

(i) Most boards and community organisations have a provision in their respective rules and regulations that obligate the member to disclose the fact that they have either become bankrupt or entered into an agreement under Part 1X or Part X of the Bankruptcy Act. In some cases that will lead to their exclusion from membership of the board or organisation.

Permanent record of bankruptcy

A permanent record of the person's bankruptcy is recorded on the National Personal Insolvency Index ("NPII") which is a register kept by ITSA of all persons who have become bankrupt since 1928.The NPII also record all persons who have entered into an arrangement with their creditors under either Part 1X or Part X of the Act or have been subject a Creditor's Petition since 1928.

Possible restricted access to credit

Credit reporting agencies such as Veda Advantage keep the above details for a period of 7 years. Accordingly, when a person is discharged from

bankruptcy after the normal 3 year period they may encounter difficulty in obtaining credit for the following 4 years. However, given the abundance of credit currently available and the new lenders in the market place that provide an alternative to the traditional credit providers, a person discharged from bankruptcy will probably be able to obtain credit without any great difficulty.

Fresh start

Bankruptcy causes some people feel shame and embarrassment whilst others feel a sense of relief and take the opportunity to evaluate their lifestyle and spending habits. Whilst some facing bankruptcy think that it will be the end of the world for them and that they will never get back on their feet ever again, others go onto greater heights.

Notable examples being Garfield Barwick who notwithstanding that he became bankrupt when he was a young barrister, went on to have a most distinguished legal career culminating in his appointment as Chief Justice of the High Court of Australia.

Likewise, a young builder Lesley Joseph Hooker who became bankrupt in 1928 went on to establish a well known real estate business.

Bankruptcy: Breakdown of personal relationships

Bankruptcy or the events that led to the debtor becoming insolvent often result in the breakdown of a marriage or relationship.

A common scenario is where the husband is spending an increasing amount of time trying to stop his business from failing and consequently he is spending less time tending to his duties and responsibilities on the home front.

It is quite common for an insolvent debtor to be having matrimonial problems and, as a result, often the husband's creditors are taking bankruptcy proceedings against him in the Federal Court or Federal Magistrate's Court, whilst his wife is taking family law proceedings against him in the Family Court.

Not in all cases does the wife know of the extent of her husband's insolvency and, conversely, the husband's creditors are often unaware of the Family Court proceedings. The Family Law Act places an obligation on each spouse to make a full and truthful disclosure of their financial circumstances in property settlement proceedings however, this does not always occur.

Where there are both bankruptcy and family law proceedings on foot, whichever Court Order is made first is binding. viz. if prior to the husband becoming bankrupt, the Family Court orders that his half interest

in the matrimonial home and/or other assets be transferred to his wife in consideration of future maintenance of their children, that Order is binding on the trustee until such time as the Family Court sets its previous Order aside.

Alternatively, if the husband becomes bankrupt before the Family Court makes an Order in respect of his assets, his property vests in the trustee **in the first instance**.
However, changes to the Family Law Act and the Bankruptcy Act which commenced in **September 2005**, now enable a non-bankrupt spouse to continue or commence an application to the Family Court for a property settlement and/or an order for maintenance against their bankrupt spouse and seek an order from the Family Court that the trustee of the bankrupt spouse's estate transfer "*vested property*" (property of the bankrupt spouse that has vested in the trustee), to the non-bankrupt spouse **to** satisfy the terms of the property settlement and/or the bankrupt spouse's liability for maintenance.
In making such an order, the Family Court is required to consider the interests of all the parties including the effect of the proposed order on the creditors of the bankrupt spouse. However in the majority of cases decided to date, the creditors have not fared well and it appears that the Family Court continues to place the utmost importance on the welfare of the children of the marriage and their current primary carer (usually their mother)
The majority of married couples own their matrimonial home as *"joint tenants"* because upon the death of one of them, the half interest in the home of the deceased spouse passes automatically to the surviving spouse under the *"doctrine of survivorship"*.
No stamp duty is payable when such transfers are registered at the Land Title Office.

However in some cases the non-bankrupt spouse has financially contributed a greater proportion to the acquisition of the property eg provided the deposit and/or paid off a substantial portion of the mortgage with moneys they received the deceased estate of one of their relatives etc and/or the they had allowed their half interest in the property to be mortgaged to secure a debt incurred solely by the bankrupt.

Prior to the High Court decision in the matter *The Trustees of the Property of John Daniel Cummins, A Bankrupt v Cummins* [2006] HCA

6, bankruptcy trustees would consider submissions from the non-bankrupt spouse in such cases and if the claim for a "*resulting trust*" and/or "*exoneration*" was substantiated, the trustee would allow the non-bankrupt spouse a greater than 50% interest in the actual or notional proceeds from its sale.
In the event that only one spouse becomes bankrupt, the trustee will normally invite the non-bankrupt spouse to purchase the bankrupt's interest in the property or if they are unable to do so, join with the trustee in selling the property.
However, since that case which established what is now commonly known as the "***Cummins Principle*"**, the situation has drastically changed for such non-bankrupt spouses because the *Cummins Principle* stated simply means…. **Matrimonial property, irrespective of whose name or names it is registered in, unequal contributions to its acquisition, only one spouse received the benefit from borrowings against it, is owned 50/50 by the spouses.**

The *Cummins Principle* has been applied by the Federal Court, the Federal Magistrates Court and the Family Court since the High Court decision in 2006.
In the case of *Lemnos and Lemnos & Anor [2007] FamCA 1058,* Mr Lemnos who had been a partner in large well known law firm in Sydney and had been made bankrupt on the petition of the ATO in respect of a debt of approx$4.5 M, was the sole registered owner of a house property in which there was a net equity of approx $3M. Accordingly, the ATO anticipated that it would recover a substantial portion of its debt from the sale of the property by the trustee.
However, the Court agreed with the submission by Mrs Lemnos (the non-bankrupt spouse) that the *Cummins Principle* should apply and accordingly, the Court ordered that she receive 50% of the net proceeds from the sale of the property.

In a recent case *Worsnop & Worsnop (No. 2) [2007] FamCA 1315 (9 November 2007)* the ATO which is owed approx $13M by Mr Worsnop, intervened in the Family Court proceedings in which Mrs Worsnop successfully sought 50% of the net proceeds from the sale of an unencumbered property registered in the sole name of Mr Worsnop (worth approx$4.75 M). The ATO has appealed

the decision which result in Mrs Worsnop receiving approx $2.35 M, and the Full Family Court has expedited the hearing of the appeal as it is aware of at least 10 other cases including the Lemnos case, which are based on similar facts and issues

However, in the cases of *Pascoe v Nguyen [2007] FMCA 194 (2 March 2007)* and *Official Receiver v Huen [2007] FMCA 304 (16 March 2007,* the Court applied the *Cummins Principle* not withstanding that each non-bankrupt spouse had asserted that they had contributed the major portion, if not all of the acquisition costs of their respective jointly owned homes.
Interestingly, Mrs Nguyen argued that she was not legally married to the bankrupt and accordingly the *Cummins Principle* did not apply (It is understand that it applies only to heterosexual married couples at this stage)
However, the Court rejected her argument on the basis that both she and the bankrupt had declared to the Immigration Department that they were married and Mrs Nguyen had commenced divorce proceedings against the bankrupt in the Family Court. (It is pre-requisite to divorce proceedings that the parties be legally married)

In the case of *Witt and Witt and Anor FMCA FAM 681 (20 September 2007),* the trustees of the bankrupt husband unsuccessfully endeavoured to resist the non-bankrupt wife's application under the Family Law Act that she be awarded the sole ownership of their jointly owned home. In addition to the Court ordering the trustees to transfer the bankrupt husband's half interest in the home to his wife, the Court ordered that the wife be paid 95% of the bankrupt's superannuation fund(which currently had accumulated balance of $50,000) when it matured. The wife was entitled to retain her superannuation fund which had accumulated balance of $9,000
In making the orders the Court took into consideration a number of factors which made this case somewhat less than ordinary, including the following:

- Mrs Witt was the primary care-giver to their seven children, and
- Mrs Witt has the ongoing care of the three children still at home, and

- Mrs Witt has had the primary responsibility for the children's' physical, mental emotional and intellectual needs and
- Mr Witt has had very little to do with the children during the marriage and since leaving, and
- Mrs Witt's role as homemaker and all the tasks that role involves was uncontroverted, and
- Mrs Witt raised seven children whilst working on and off throughout the duration of the marriage.
- Mr Witt has remarried whilst Mrs Witt has not re-partnered
- Mr Witt had been assessed to pay $146 per week child support for the 2 youngest children and he was currently $1,732 in arrears of such assessment.

Amendments made to the Family Law Act in **December 2004**, empowered the Family Court to transfer, apportion and/or extinguish the liability of a spouse to a creditor.
In the case of where the spouses are jointly liable for a debt(s) and one spouse becomes bankrupt, and the Family Court orders that the bankrupt spouse becomes solely liable for the debt, there would be no practical impact on the creditors of the bankrupt spouse, as the extent of his or her liabilities has not changed.
However, if the Family Court ordered that the bankrupt spouse become liable for a debt that the non-bankrupt spouse was previously **solely** liable for, there will be a significant impact on the bankrupt estate where a partial dividend (less than 100c) is to be paid to creditors, as the rate of dividend will be reduced with the additional creditor sharing in the distribution.

Taxation issues

a) Outstanding Returns
It is quite common for debtor becoming bankrupt to have one or more income tax returns outstanding. Whist the debtor is not precluded from becoming bankrupt because they have not lodged a tax return for say four years, the Australian Taxation Office ("ATO") is notified of all persons becoming bankrupt. Upon receipt of such advice, the ATO checks to see if the bankrupt has any outstanding tax returns, and if so, advises the bankrupt of their requirement (ie. not the trustee's) to lodge the outstanding returns and the consequences that will follow if they=y fail to do so.

b) Tax liability released upon discharge from bankruptcy.

As the ATO operates in "financial years", the bankrupt's liability for unpaid tax up to the end of the financial year (usually 30th June) **prior to the date of bankruptcy,** is released upon his or her discharge from bankruptcy, irrespective of when the returns are lodged and assessed.

If the bankrupt has been operating a business on their own account up to the date of bankruptcy or shortly before and they become bankrupt in the second half of the financial year, they may wish to consider lodging two tax returns for the one financial year.
Whilst there will be the added cost of having their accountant prepare an additional return, they will be relieved of their accrued tax liability up to the day before bankruptcy.
Note. There is no financial benefit for salary and wage earners in lodging two tax returns for the one financial year.

c) Tax refunds
The ATO has the right to retain tax refunds and apply the refunds to the reduction of any liability that the taxpayer has to the ATO and/or other Commonwealth Agency (eg.Centrelink, Child Support Agency etc)

Subject to the ATO's right of retention, tax refunds for financial years that ended **prior** to the date of bankruptcy **irrespective of when the returns are lodged and assessed,** are classed as assets in the bankrupt's estate and accordingly are payable to the trustee.
Conversely, refunds for full financial years ending after the date of bankruptcy, are payable to the bankrupt, and refunds for the year in which the bankruptcy occurred are split between the trustee and the bankrupt on a pro-rata basis.
Note. Whilst the ATO is entitled to indefinitely retain tax refunds and apply the refunds to the bankrupt's liability for unpaid tax at the date of bankruptcy, it has a policy that such practice is restricted to the period of bankruptcy (generally, three years)

Note. Director Penalty Notices issued by the ATO: see later in paper under the heading "***Personal guarantees"***

Business operating at the date of bankruptcy

a) Operated as a sole trader
If the business has assets (other than tools of trade) and it appears to the trustee that the business is not operating at a profit, the trustee will normally close down the business immediately and sell off the assets.

If on the hand, if the trustee ascertains that the business is profitable then the trustee will normally sell the business as a going concern and engage the bankrupt to continue operating the business until a sale is effected. In such cases, the trustee becomes personally liable for the liabilities incurred by the business from the time the trustee took control of it. Accordingly, the trustee will ensure that full insurance coverage is in place and that the creditors supplying goods and services to the business are advised that they can only look to the trustee for payment in respect of goods and services supplied **after** the trustee took control. Likewise with any staff that were owed moneys for wages and entitlements at the date of bankruptcy, and continue to work in the business.

Where the business comprises the provision of a service or services and it does not have assets (other than tools of trade) the bankrupt is entitled to continue the business subject to certain restrictions and obligations. Viz

i) The bankrupt will need to either obtain a new ABN from the ATO or obtain the consent of the ATO to continue using the same ABN in which case, the ATO will note the date of bankruptcy on its records and look to the bankrupt for the payment of all tax liabilities incurred after that date

ii) The bankrupt will be informed by the trustee of his or her responsibility to lodge BA statements and promptly pay all liabilities to the ATO as they arise, and that the ATO will take swift action against them if they fail in that regard.

iii) They may trade under their own name however if they trade in another name (eg Acme Enterprises) which does not contain their name, they are required to inform every person with whom they deal that they are an undischarged bankrupt. Failure to do so is an offence under the Bankruptcy Act which is punishable upon conviction, with a maximum penalty of **three years imprisonment.**

iv) Whilst they can incur credit, if the amount incurred exceeds the prescribed limit (currently $4,623) they are required to disclose their bankruptcy status to the prospective credit provider. Failure to do so is an offence under the Bankruptcy Act which is punishable upon conviction, with a maximum penalty of **three years imprisonment.**

v) Under S.116(2) of the Bankruptcy Act, a bankrupt is entitled to keep their "tools of trade " up to a prescribed value (currently$3,250, based on **auction value**) or other amount as agreed by the creditors or ordered by the Court.

Note. The Trustee will determine whether certain assets such as hydraulic jacks etc are classed as "tools of trade" which are protected up to the

prescribed limit or plant & equipment which is not protected. Normally, if the items in question are portable they are classed as tools of trade.

b) **Operated as a partnership.**
Unless the partnership agreement states otherwise (which would be highly unusual) a partnership comes to an end when one or more of the partners becomes bankrupt.
The trustee will call on the non-bankrupt partner(s) [usually called the "solvent partner"] to actually or notionally wind up the partnership business.
In most cases, it will be a notional winding up in that financial accounts will be prepared for the business as at the date of bankruptcy and the value of the bankrupt partner's net equity ascertained which the solvent partner(s) will be invited to purchase from the trustee.
In some cases, there may be an actual winding up whereby the solvent partner(s) will sell the business, pay out the partnership's liabilities and pay the value of the bankrupt's net resulting equity to the trustee.
If the solvent partner(s) refuse to take either option and it is financially viable to do so, the trustee will seek an order from the Court that the trustee wind up the partnership or the Court appoint a Receiver to do so.

c) **Operated as a company**
If the bankrupt is the sole director and shareholder of the company and the value of the company's assets exceed its liabilities, the trustee will normally move to wind up the company.

If the bankrupt is not the beneficial owner of all the shares in the company, the trustee will ascertain the value of the bankrupt's shares in the company and invite the other shareholder(s) to purchase the bankrupt's shares or introduce an approved purchaser for the shares.
If the shareholder(s) refuse to take either option and it is financially viable to do so, the trustee will seek an order from the Court that the company be wound up so as to realise the bankrupt's interest therein.

Personal guarantees
Sometimes the bankrupt has been a director of a company but nor a shareholder (ie they have no proprietary interest in the company) but have given personal guarantees to suppliers of goods and/or services to the company on credit.
If the company fails to pay such debts the director is then often called on to pay the debt pursuant to the terms of their personal guarantee.

Directors can also become personally liable for unpaid income tax deductions from the wages of company employees under the Income Tax Assessment Act ("ITAA"). If the ATO issues a director with a **Director Penalty Notice** and if the company does not within the prescribed period (14 days), pay the liability owing to the ATO, enter into a Deed of Company Arrangement or be placed into Voluntary Liquidation, the director becomes personally liable for tax liability of the company.

Insolvent trading

There are various provisions in the Corporations Act that prescribe that if a director of a company allows the company to keep trading whilst insolvent (*ie. the company is unable to pay its debts from its available financial resources) the director becomes personally liable for the debts of the company.
Whilst individual creditors are entitled to seek orders of the Court that the director is personally liable for the debts of the company by allowing it to keep trading whilst insolvent, normally the liquidator of the company makes the application to the Court on behalf of all creditors.

RELEASE FROM BANKRUPTCY

General Discharge

The normal term of bankruptcy is **three years and one day from the date the bankrupt files his or her Statement of Affairs** after which the bankrupt is discharged. There is also provision under the Act to extend the period of bankruptcy to either five years or eight years, depending on the grounds of the objection to discharge lodged by the trustee.

Annulment of bankruptcy

There are three (3) ways to obtain an annulment of bankruptcy:-

1. ***Annulment by Order of the Court Section 153B***

The Federal Court or Federal Magistrates Court has the power to annul a bankruptcy only on the grounds that a sequestration order ought not to have been made or a debtor's petition ought not to have been presented or accepted.
The record of the bankruptcy and the annulment thereof are recorded permanently on the NPII.
(**Note.** The Federal Court and Federal Magistrates Court are both empowered by the Federal Court Act and Rules in certain circumstances to **set aside** a sequestration order, which has the effect of *"extinguishing"*

the bankruptcy as if it had never occurred. Consequently, the record of the creditor's petition and the sequestration order are **deleted from the NPII** when the sequestration order is set aside. This occurs when for example, the debtor was solvent and has paid the petitioning creditor's debt, and the application is made within 21 days of the making of the sequestration order)

2. *Automatic Annulment upon Payment in Full: s. 153A*
Where the trustee is satisfied that all of the bankrupt's debts have been paid in full the bankruptcy is annulled by operation of law, from the date on which the final payment was made.
"*Bankrupt's debts*" are defined as:-

........all debts that have been proved in the bankruptcy and includes interest payable on such of those debts as bear interest, and the costs, charges and expenses of the administration of the bankruptcy, including the remuneration of the trustee"

3. Automatic Annulment upon Acceptance of Composition or Scheme of Arrangement (Section 74)

In a composition, the bankrupt with the financial assistance of a friend, relative etc, makes an offer of a lump sum of money to creditors whereby the creditors are asked to accept a certain percentage of their debt in full satisfaction thereof (eg. 60 cents in the $), on the basis that they will not receive a greater return from the bankrupt estate.

Upon the passing of a special resolution at a meeting of creditors accepting a composition or scheme of arrangement submitted by the bankrupt, his or her bankruptcy will be annulled by operation of law, notwithstanding that the dividend will be paid to creditors at a later date. Accordingly, the trustee will normally require the composition funds to be deposited with the trustee prior to the meeting of creditors to consider the offer, or be secured by a bank guarantee. In the event that creditors do not accept the offer, the funds would be returned to the provider thereof.

ALTERNATIVES TO BANKRUPTCY

Informal Arrangement
If the debtor has a small number of creditors who are owed reasonably small amounts **and the creditors have not lost patience**, the debtor with the assistance of a third party such as a financial counsellor, accountant,

solicitor, parent etc. may be able to come to an arrangement with creditors to pay off the debts. It is essential that **all** creditors agree to the proposal.

Debt Agreement - Part IX

The debtor can submit a proposal to creditors via the Official Receiver (part of ITSA) whereby the debtor offers to make periodic payments and/or pay the proceeds from the sale of their property to a nominated Debt Agreement Administrator ("DAA"),to be accepted by creditors in full satisfaction of their debts.

As from **1st July 2007**, only an *ordinary resolution* (at least 51% in value of the creditors) is required to accept the proposed Debt Agreement ("DA")

There are monetary limits on the extent of the debtor's assets, liabilities and income in respect of those debtors who are able to submit a DA proposal which are currently **$80,262.00 for assets and liabilities and $60,196.50 for after-tax income**.

Generally, the cost of administering a DA is much less than a Part X or bankruptcy, which results in a greater return to creditors.

Initially, DAAs were not required to hold any qualifications or have any commercial experience. However, due to complaints received about a small number of DAAs, the Act has been amended whereby as from **1st July 2007**, all DAAs (other than Registered Trustees and the Official Trustee) now need to register with ITSA and to obtain such registration they will need to have prescribed qualifications and experience. Furthermore, the Act has imposed increased obligations on DAAs to ensure that:

a) The debtor has been fully informed of the options available under the Act and the obligations placed on a debtor entering into a DA with their creditors, and
b) The debtor has made a full and proper disclosure of all their financial affairs including all their liabilities, assets and income, and
c) The debtor's proposal offers the same rate of dividend to all unsecured creditors, and
d) The debtor's proposal is a viable one ie. The debtor can afford to make the proposed payments, and
e) Dividends are distributed to creditors in a timely manner, and
f) The DAA will take his or her fees over the life of the DA in proportion to the work carried out up to that time, and **not** in priority to creditors, and

g) Creditors are notified of the debtor's default after 3 months of non-payment has elapsed.

The amendments enable a DA to be terminated automatically where the debtor has not made any payments for 6 months, and streamline the process for varying the terms of a DA during its operation.

A debtor will not be released from their provable debts **until** they have completed their obligations under the DA.(**Note**. A DA cannot release a debtor from a debt that is not released by bankruptcy .eg maintenance, student loans, court imposed fines etc)

Personal Insolvency Agreements: Part X

A Personal Insolvency Agreement ("PIA') is a more formal version of a Debt Agreement; however there are no monetary limits on the debtor's assets, liabilities or income

The Act prescribes a number of requisite terms such as how the debtor's assets and income are to be dealt with under the PIA plus a number of optional terms eg. Antecedent provisions may or may not apply to the debtor's property, offering increased/decreased rates of dividend to different types of creditors.

There are also increased obligations on the debtor, the controlling trustee and creditors to disclose their relationship with each other.

Likewise, the amendments placed an obligation on the controlling trustee to enhance the quality and extent of the controlling trustee's report to creditors on the debtor's proposal including a comparison with the return creditors could expect if the debtor became bankrupt, so that creditors can be better informed when they consider whether it is in their best interests to accept or reject the debtor's proposal.

The changes were designed to make the make the overall process more flexible and to streamline the variation and termination of agreements. However it appears that the increased obligations imposed on controlling trustees have caused an increase in the cost of administration with a resulting decrease in the number of debtors submitting Part X proposals to their creditors.

With both DAs and PIAs, it is essential that the proposal is put the creditors sooner than later, and that the proposal is both reasonable for creditors and achievable by the debtor.

CONCLUSION

Therefore, it is my personal view that for a debtor, bankruptcy is not really a soft option given the limitations and obligations it imposes on a debtor. However, given the present commercial environment where there is an apparent abundance of money available for lending and an abundance of organisations to lend it, bankruptcy can relieve a debtor from the burden of debt they have accumulated and have no reasonable prospects of repaying.

Conversely, for a creditor the bankruptcy process can provide a cost effective means of debt recovery against a recalcitrant debtor.

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