



Miles and Dowler, *A Guide to Business Law 21st edition*

Study Aid – Chapter summaries

Chapter summary – ch 17 – debt recovery and bankruptcy

A. The purpose of bankruptcy proceedings

1. An **insolvent** person is a person who cannot meet his or her debts as they fall due. This is not the same as being bankrupt. A **bankrupt** is a person who has been declared by a court as being unwilling or unable to meet his or her debts.
2. The purpose of bankruptcy proceedings is to provide an orderly method of distributing the assets of such a person fairly among creditors.
3. Bankruptcy has some advantages for creditors:
 - payment of debts is proportionately rather than on a first-come first-served basis;
 - inquiry into bankrupt's prior conduct; and
 - administration of bankrupt's affairs by a skilled person.
4. Bankruptcy has some advantages for the bankrupt:
 - no more pressure from creditors to pay debts;
 - under the Act, creditors are precluded from taking further action against the bankrupt; and
 - eventual discharge from bankruptcy gives a fresh financial start.
5. The process also has some disadvantages for both parties. For example, creditors may be in a class who receives nothing since assets were paid out to earlier creditors. The bankrupt has the stigma of bankruptcy attaching to him for many years, even after discharge.

B. Administration of bankruptcies

In Australia, insolvency and bankruptcies are administered by the Australian Financial Security Authority (AFSA) (formerly ITSA). The Federal Court provides sequestration orders which formally declare a person bankrupt after lodgment of a creditor's petition. The Federal Circuit Court may also deal with some non-contentious bankruptcy matters.

C. Steps to bankruptcy

The creditor **must** take debt recovery action against the debtor to be able to proceed



further in bankruptcy.

Steps in the recovery process *prior to* the bankruptcy process include:

- issue of a letter of demand (this is not a legal necessity, but is a step most creditors will take in a last attempt to obtain payment);
- issue of the Statement of Claim (commonly known as the summons);
- service of the summons on the debtor; and
- entering judgment.

Once the creditor has obtained judgment, he can *enforce* the judgment against the debtor in the following ways:

- issue of a garnishment order against the debtor's wages or bank account;
- issue of a Writ of Execution allowing the Sheriff to “red tag” debtor's goods for sale at a public auction; and
- issue of an Examination Summons, where the debtor is cross examined under oath as to his assets and liabilities.

The debtor can also apply for an Instalment Order, which allows him to pay off the debt, *but* if this is done, the creditor will still receive his judgment.

If none of these methods are successful, then the creditor may petition for bankruptcy.

Although the creditor' petition is more common, a person can actually become bankrupt in two ways:

1. Debtor's petition

- (a) The debtor applies to the AFSA for his or her own bankruptcy giving full details of financial affairs. If AFSA is satisfied that the applicant is insolvent, it will recommend to the Official Receiver that the petition is accepted and the applicant is bankrupt.
- (b) Amendments to current bankruptcy legislation (see para 2, below) will make it more difficult for debtors to have their petitions accepted without question.

2. Creditor's petition

- (a) Any creditor owed at least \$5,000 (this is known as the “prescribed amount” and varies from time to time as the cost of living increases) can lodge a creditor's petition based upon the commission by the bankrupt of an **act of bankruptcy** within the last six months. If the Official Receiver is satisfied that the debtor is insolvent, he will make a **sequestration order**. This means that all the property of the debtor vests in a trustee for the benefit of creditors. The



debtor is now a bankrupt.

- (b) The Act lists 14 actions which are **acts of bankruptcy**. They include:
- debtor conveying all (or substantially all) his or her property for the benefit of creditors generally;
 - debtor disposing of property or paying money in circumstances that would make the disposition or payment voidable in the event of the debtor becoming bankrupt;
 - debtor failing to comply with a bankruptcy notice (a judgment creditor for at least \$5,000 can serve a bankruptcy notice on the judgment debtor requiring payment of the sum, or satisfactory arrangements, within 21 days – failure by judgment debtor to comply with notice is an act of bankruptcy);
 - execution levied, successfully or otherwise, against the debtor's property to satisfy payment of a judgment; and
 - debtor absenting himself or herself for the purpose of delaying or defeating creditors.

D. Proceedings after bankruptcy

1. The effect of a **sequestration order** is that the debtor becomes bankrupt until discharge and all property passes to the trustee in bankruptcy.
2. A bankrupt has certain legal liabilities. He or she:
 - cannot act as director or manager of a company;
 - needs permission of trustee to travel outside Australia; and
 - must disclose bankruptcy before obtaining credit over prescribed amount.
3. The trustee must now gather in all the bankrupt's property, sell it and distribute the proceeds among creditors.
4. Creditors must prove their debts to the trustee. Secured creditors can rely upon their security but, at their option, can give up the security and prove as an unsecured creditor.

E. Property of the bankrupt

The trustee can realise upon the bankrupt's property which excludes **exempt** property but includes property:

- owned at date of sequestration order;
- acquired during bankruptcy;



- owned at date of commencement of bankruptcy; or
- of an associated entity.

1. **Exempt property**

The trustee has no right to:

- property held in trust for others;
- necessary clothing and furniture;
- tools of trade or reference books to the value of \$3550;
- motor vehicle to the value of \$7200;
- life policies in force for two years;
- endowment policies in force for five years; or
- proceeds of personal accident claims.

2. **Property owned at date of sequestration order**

The trustee is entitled to all property owned at the date of making the sequestration order.

3. **Property acquired during bankruptcy**

All property acquired during the period of bankruptcy vests in the trustee for the benefit of the creditors. This does not include income except:

- where court orders part of income to go to creditors; or
- in respect of bankrupts whose income is above a certain level, a prescribed percentage goes to creditors.

4. **Property owned at date of commencement of bankruptcy**

To find this date, take the date of the creditor's petition (or the date of acceptance of debtor's petition) and go back six months. The date of the first act of bankruptcy that occurred in this period is the date of commencement of bankruptcy.

The principle of **relation back** states that all property owned by the bankrupt on and after this date vests in the trustee. The trustee can recover it from any person to whom the bankrupt transferred it unless that person can show that it was:

- made before the date of bankruptcy;



- the recipient had no notice of presentation of a petition; and
- the transaction was in good faith and in the ordinary course of business (“an ordinary business transaction”).
- Similarly, a debt paid to a creditor or delivery of property made to a person in this period would give that creditor or person an unfair advantage. The trustee can upset such a transaction unless the creditor or other person can show:
 - if it was made before the date of bankruptcy, it was made in good faith and in the ordinary course of business; or
 - if made after the date of bankruptcy, it was made in good faith and in the ordinary course of business and without negligence.

5. **Property of a controlled entity (formerly associated entity)**

The trustee may be able to take in property of a controlled entity. A controlled entity is a person (natural or artificial) that is subject to the influence of the bankrupt.

F. Voidable transactions

A trustee may be able to set aside dispositions of property or payments by the bankrupt before bankruptcy. There are several situations.

1. **Voidable preferences**

Section 122 allows the trustee to void any payment to a creditor which would give a preference over other creditors if made within six months before the petition or between petition and bankruptcy. The trustee must show that:

- the debtor was at the time insolvent;
- the other party was a creditor;
- the transaction resulted in a preference; and
- the transaction took place within a period of six months before the petition was presented or in the period between presentation of petition and bankruptcy.

The creditor can escape the provisions of s 122 by showing good faith and that the transaction was in the ordinary course of business.

2. **Other voidable transactions**

A transfer of property made by a person who later becomes a bankrupt is void against the trustee if:



- the transfer took place in the period five years before the commencement of the bankruptcy; and
- the transferee gave no consideration or a consideration less than market value.

The transaction is not, however, void if it took place more than two years before the commencement of the bankruptcy and the transferee can show that the debtor was solvent at the time of transfer. The trustee cannot recover the property if it has been subsequently acquired by another person in good faith and for at least the market price.

Fraudulent transactions: s 121 allows a trustee to void any transfer of property made deliberately to delay or defeat creditors. There is no time limit for such transactions.

G. Priority of payment of debts

The *Bankruptcy Act 1966* effectively divides unsecured debts into:

1. **Preferred debts** are paid in priority to all other debts and have a priority within themselves. They include, in order of priority:
 - (a) Child support deductions.
 - (b) Costs of trustee and petitioning creditor.
 - (c) Fees/costs to any trustee or solicitor where a Pt X agreement preceded bankruptcy.
 - (d) Funeral expenses where the bankrupt died.
 - (e) Wages up to approx \$4000 for each employee
 - (f) Workers' compensation payments.
 - (g) Long service leave, holiday pay and sick leave owing to employees.
 - (h) Fees paid by discharged apprentices or articled clerks to the employer who is now bankrupt.
 - (i) Payment to creditors which have been approved by a general meeting of creditors.
2. **Ordinary debts** are paid in proportion after all preferred debts are paid. Ordinary creditors are creditors who are not preferred creditors or who are not deferred creditors.
3. **Deferred debts** are only paid after all ordinary debts are satisfied. The most common deferred creditor is a related entity, such as the bankrupt's spouse.

H. Discharge

A bankrupt is automatically discharged after three years unless:

- discharged previously by the court, on the application of the bankrupt; or
- the court extends the period of bankruptcy on the application of the trustee (this can be 5-8 years).

I. Alternative arrangements

The debtor can make alternative arrangements with creditors under **Part X** of the Act. Here the debtor does not undergo the disadvantages of a bankrupt or suffer any stigma. These have now been replaced by just one type – the Personal Insolvency Agreement.

J. Changes to bankruptcy laws

Changes to the Act in 1996 include the setting up of a simplified procedure for small insolvencies. These are known as “Debt Agreements” (Pt IX of the Act).

The basic arrangement is that the debtor, with the consent of a majority of her or his creditors, can enter into the “Debt Agreement” which will specify a process for paying all or part of the moneys owing. However, the procedure is also subject to a form of “means” testing. For instance, the debtor’s debts must not exceed \$106,561.00* and his assets should also not exceed this amount. The debtor must not have been bankrupt, had another debt agreement, or signed an authority to enter a Pt X Agreement in the previous 10 years. The debtor must not have an after-tax income in excess of \$79,920.75*. With the increase in the assets figures and after-tax, this process allowed the debtor to avoid the consequences of bankruptcy and to establish an orderly scheme for the satisfaction of her or his obligations. Recent changes have been introduced to the administration of Debt Agreements.

*These limits are current as at October 2014. Limits are updated twice a year on 20 March and 20 September.

K. Personal Property Securities Register

AFSA administers the Personal Property Securities Register which allows checks on asset encumbrances.