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taxation and commercial

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## Bankruptcy Training Session

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<b>1</b>	<b>The 'bankruptcy' process .....</b>	<b>4</b>
1.1	Overview .....	4
1.2	Bankruptcy VS insolvency.....	5
1.3	Application of the Bankruptcy Act .....	5
1.4	Debts and creditors .....	5
<b>2</b>	<b>Consequences of becoming bankrupt.....</b>	<b>6</b>
2.1	The Bankrupt Estate .....	6
2.2	Restrictions on undischarged bankrupt .....	8
2.2.1	<i>Disclosure of bankruptcy</i> .....	8
2.2.2	<i>Appointment as a director</i> .....	9
2.2.3	<i>Employment</i> .....	9
2.2.4	<i>Overseas travel</i> .....	9
2.2.5	<i>Legal actions</i> .....	9
2.3	Obligations of the bankrupt .....	9
<b>3</b>	<b>How to determine if a person is bankrupt? .....</b>	<b>10</b>
<b>4</b>	<b>How can a person be released from bankruptcy? .....</b>	<b>11</b>
<b>5</b>	<b>Assessing borrowing applications from former bankrupts .....</b>	<b>12</b>

All references in this paper are to:

- the *Bankruptcy Act* 1966 (Cth) (**'the Bankruptcy Act'**);
- the *Bankruptcy Regulations* 1996 (Cth) (**'the Bankruptcy Regulations'**);
- the *Corporations Act* 2001 (Cth) (**'the Corporations Act'**); and
- the *Migration Act* 1958 (Cth) (**'the Migration Act'**).

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## 1 The 'bankruptcy' process

### 1.1 Overview

Subsection 5(1) of the Bankruptcy Act defines the term 'bankrupt' to be:

"**bankrupt**" means a person:

- (a) against whose estate a sequestration order has been made; or
- (b) who has become a bankrupt by virtue of the presentation of a debtor's petition.

That is, there are two ways in which a person can become bankrupt, being:

- **Involuntarily** – the right of a creditor to enforce the status of 'bankrupt' on a debtor if a debt remains unpaid. This method involves a sequestration order being made by the Court as a result of an application being made by a creditor, which results in the debtor becoming 'bankrupt'; and
- **Voluntarily** – this occurs where a debtor presents a debtor's petition, which is presented to the Official receiver. The debtor must meet certain limitations set out in the Bankruptcy Act before the petition would be accepted by the Official Receiver in Bankruptcy. If there are no pending applications by creditors to bankrupt the debtor, and if the petition is accepted, then the debtor will become bankrupt.

With respect to involuntary bankruptcies, a creditor (who must be owed a debt of \$2,000 or more) wishing to initiate bankruptcy proceedings must show that the debtor has committed an 'act of bankruptcy'. This is typically shown via a non-compliance with a 'bankruptcy notice' served on a debtor. The creditor must present to the Court, within six months of the commission of an 'act of bankruptcy', a creditor's petition. The Court must then decide whether a sequestration order should be made.

Generally speaking, bankruptcy proceedings are commenced by the creditor presenting a 'creditor's petition' to the Court (see section 44 of the Bankruptcy Act). The petition seeks the 'sequestration' of the debtor's estate, which causes bankruptcy to commence if a sequestration order is obtained. Section 43 of the Bankruptcy Act provides that:

#### **Jurisdiction to make sequestration orders**

- (1) Subject to this Act, where:
  - (a) a debtor has committed an act of bankruptcy; and
  - (b) at the time when the act of bankruptcy was committed, the debtor:
    - (i) was personally present or ordinarily resident in Australia;
    - (ii) had a dwelling-house or place of business in Australia;
    - (iii) was carrying on business in Australia, either personally or by means of an agent or manager; or
    - (iv) was a member of a firm or partnership carrying on business in Australia by means of a partner or partners or of an agent or manager;

the Court may, on a petition presented by a creditor, make a sequestration order against the estate of the debtor.

- (2) Upon the making of a sequestration order against the estate of a debtor, the debtor becomes a bankrupt, and continues to be a bankrupt until:
- (a) he or she is discharged by force of subsection 149(1); or
  - (b) his or her bankruptcy is annulled by force of subsection 74(5) or 153A(1) or under section 153B.

The relevant government agency responsible for matters relating to bankruptcy is the Insolvency and Trustee Service Australia ('ITSA').

## 1.2 Bankruptcy VS insolvency

### Q: Is insolvency different to bankruptcy? How?

Bankruptcy is different to insolvency. Insolvency occurs if you are unable to pay your debt as and when they fall due. There are a number of options available to an individual who is insolvent and bankruptcy is merely one of the many options.

In a voluntary bankruptcy, the debtor may only commence bankruptcy proceedings if the debtor is insolvent.

## 1.3 Application of the Bankruptcy Act

### Q: Are there different types of bankruptcy? What is the difference between personal and commercial bankruptcy?

It should be noted that the Bankruptcy Act applies to persons, partnerships and limited partnerships. Bankruptcy can also occur to persons under the age of 18.

Corporations, and partnerships or associations registered under State or Territory law that provides for the winding up of a partnership or association registered under that law are not subject to the Bankruptcy Act<sup>1</sup>. Rather, corporate entities are placed into receivership, voluntary administration or liquidation under the Corporations Act.

## 1.4 Debts and creditors

There are two types of debts which must be disclosed by the bankrupt in the Statement of Affairs, being debts which are provable or non-provable. Creditors of provable debts are entitled to share in any dividends from the administration of the bankruptcy, and to vote at meetings. Examples of provable debts include credit card debts and personal loans incurred before bankruptcy. Examples of non-provable debts include unliquidated damages, debts incurred after the date of bankruptcy, and penalties and fines imposed by a Court.

The Bankruptcy Act expressly states that the rights of a secured creditor of the bankrupt to realise or otherwise deal with the security is unaffected by the bankruptcy. The secured creditor may sell the security to reduce the secured debt and any shortfall resulting from the sale of the security will be a provable debt.

When a bankrupt is discharged from bankruptcy, he/she will be released from the provable debts (subject to certain exclusions such as child support). However, a bankrupt will remain liable for non-provable debts after his/her discharge from bankruptcy.

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<sup>1</sup> Section 7, Bankruptcy Act.

## 2 Consequences of becoming bankrupt

### Q: What happens after a person is declared bankrupt?

#### 2.1 The Bankrupt Estate

Unlike in the context of a company in liquidation, there is no separation of ownership and control with respect to assets of an individual. As a result, upon insolvency occurring for an individual, a separate 'bankrupt estate' is established, with the 'trustee in bankruptcy' appointed to that estate. The trustee of the bankrupt estate can either be the Official Trustee in Bankruptcy, or a registered trustee under the Bankruptcy Act.

Only assets specifically exempted from vesting in the bankrupt estate do not pass to that estate. Trust properties, certain household items and personal property of the bankrupt is excluded from being part of the bankrupt estate, as are vehicles used by the bankrupt primarily as a means of transport which has a value not exceeding the amount prescribed under the Bankruptcy Regulations (which currently stands at \$6,700). Further, interests in superannuation funds and payments from superannuation funds (except pension) are also excluded from being part of the bankrupt estate.

It is important to note that the property of the bankrupt includes choses in action, which means that generally a bankrupt will be unable to commence or continue legal proceedings.

The Bankruptcy Act distinguishes between the 'commencement of the bankruptcy' and the (later) 'date of bankruptcy'. The two periods are important, particularly under the 'doctrine of relation back'. Indeed, under section 116 of the Bankruptcy Act, a trustee in bankruptcy can claim property belonging to the bankrupt both at the 'commencement of the bankruptcy' and all property acquired by the bankrupt between the 'commencement of the bankruptcy' and the actual date of bankruptcy.

Section 115 of the Bankruptcy Act provides for the 'commencement of bankruptcy':

#### 115 Commencement of bankruptcy

(1) If a person becomes a bankrupt on a creditor's petition and subsection (1A) does not apply, then the bankruptcy is taken to have relation back to, and to have commenced at, the time of the commission of the earliest act of bankruptcy committed by the person within the period of 6 months immediately before the date on which the creditor's petition was presented.

(1A) If:

- (a) a person becomes a bankrupt on a creditor's petition that was based on breach of a bankruptcy notice; and
- (b) the time for compliance with the notice was extended under subsection 41(7); and
- (c) the Court making the sequestration order considers that the application under subsection 41(7) was frivolous, vexatious or otherwise without substantial merit;

then the bankruptcy is taken to have relation back to, and to have commenced at, the time that would have applied under subsection (1) of this section if the time for compliance had not been extended.

(1B) If a person becomes a bankrupt because of a sequestration order made under Division 6 of Part IV or under Part X, then the bankruptcy is taken to have relation back to, and to have commenced at, the time of the commission of the earliest act of bankruptcy committed by the person within the period of 6 months immediately before the date on which the application for the sequestration order was made.

- (2) The bankruptcy of a person who becomes a bankrupt as a result of the acceptance of a debtor's petition is taken to have relation back to, and to have commenced at, the time indicated in the following table.

<b>Debtor's petition bankruptcy—time to which bankruptcy has relation back and time bankruptcy commences</b>		
	<b>Circumstances in which debtor's petition was presented or accepted</b>	<b>Time to which bankruptcy has relation back and time of commencement of bankruptcy</b>
1	Petition accepted by the Official Receiver under a direction of the Court	Time specified by the Court as the commencement of the bankruptcy
2	Petition presented when at least one creditor's petition was pending against the petitioning debtor (whether alone, as a member of a partnership or as a joint debtor), and accepted by the Official Receiver without a direction from the Court	Time of the commission of the earliest act of bankruptcy on which any of the creditor's petitions was based
3	Petition presented when no creditor's petitions were pending but the debtor had committed at least one act of bankruptcy in the past 6 months, and accepted by the Official Receiver without a direction from the Court	Time of commission of the earliest act of bankruptcy within the 6 months before the petition was presented
4	Petition presented when no creditor's petitions were pending and the debtor had not committed any act of bankruptcy in the past 6 months, and accepted by the Official Receiver without a direction from the Court	Time of presentation of the petition

- (3) A creditor's petition or a sequestration order made on a creditor's petition is not invalid by reason of the commission of an act of bankruptcy before the time when the debt on which the petition was based was incurred.

Importantly, subsection 115(1) of the Bankruptcy Act provides that for a person made bankrupt under a creditor's petition, the commencement of bankruptcy is at the time of the commission of the earliest act of bankruptcy<sup>2</sup> occurring within six months immediately before the presentation of the creditor's petition.<sup>3</sup>

As mentioned above, determining the actual date of commencement of bankruptcy is crucial, as the trustee in bankruptcy can claim the property belonging to the bankrupt at the commencement date and all property acquired by the bankrupt between the commencement date and the date of bankruptcy. Paragraph 116(1)(a) of the Bankruptcy Act provides that:

Subject to this Act ... all property that belonged to, or was vested in, a bankrupt at the commencement of the bankruptcy, or has been acquired or is acquired by him or her, or has devolved or devolves on him or her, after the commencement of the bankruptcy and before his or her discharge ... is property divisible amongst the creditors of the bankrupt.

<sup>2</sup> 'acts of bankruptcy' are provided for in section 40 of the Bankruptcy Act.

<sup>3</sup> Paragraph 44(1)(c) of the Bankruptcy Act provides that a '*... creditor's petition shall not be presented against a debtor unless ... (and amongst other things) ... the act of bankruptcy on which the petition is founded was committed within 6 months before the presentation of the petition.*'

Further, paragraph 116(1)(b) of the Bankruptcy Act provides that:

Subject to this Act ... the capacity to exercise, and to take proceedings for exercising all such powers in, over or in respect of property as might have been exercised by the bankrupt for his or her own benefit at the commencement of the bankruptcy or at any time after the commencement of the bankruptcy and before his or her discharge... is property divisible amongst the creditors of the bankrupt.

It should be noted that as well as all property belonging to a bankrupt at the 'commencement of bankruptcy' and property that has been acquired by a bankrupt between the commencement of bankruptcy and the date of bankruptcy, subsection 116(1) of the Bankruptcy Act provides additional categories of property may be divisible amongst the creditors of a bankrupt.

Once a bankrupt estate is established, the trustee in bankruptcy must:

- determine the property of the bankrupt;
- recover property improperly disposed of by the bankrupt;
- realize the property recovered by the trustee in bankruptcy;
- pay the proceeds of the realized property to creditors of the bankrupt who have 'provable debts'.

Further, details of the bankrupt will be recorded in the National Personal Insolvency Index ('NPII') maintained by ITSA under the Bankruptcy Act. Details recorded on the NPII will remain on the public record permanently. The bankruptcy will also be recorded on credit rating records for a period of 7 years, starting from the commencement of the bankruptcy even if the bankruptcy is later discharged.

## 2.2 Restrictions on undischarged bankrupt

**Q: Are there any restrictions on a person while bankrupt (such as any appointment that they can't hold)?**

### 2.2.1 Disclosure of bankruptcy

Section 269 of the Bankruptcy Act prohibits an undischarged bankrupt from entering into certain transactions (either alone or jointly with another person) without informing the other party or parties to the transaction of the bankruptcy. Such transactions include:

- obtaining credit of \$3,000 or more;
- obtaining goods or services by giving a bill of exchange, cheque or promissory note;
- entering into a hire-purchase agreement or a contract or agreement for the leasing or hiring of any goods;
- obtaining goods by promising to pay;
- obtaining money by promising to supply goods or services;
- carrying on business under an assumed name, in the name of another person, or under a firm name (either alone or in partnership).

### **2.2.2 Appointment as a director**

An undischarged bankrupt is disqualified from managing corporations or be appointed a director of a company under sections 201B and 260B the Corporations Act without the permission granted by ASIC or leave granted by the Court.

### **2.2.3 Employment**

The Bankruptcy Act does not prohibit a bankrupt from working. However, if a bankrupt derives income during a contribution assessment period which exceeds the income threshold amount applicable to the bankrupt, then they are obliged under section 139P of the Bankruptcy Act to make a contribution to the trustee in bankruptcy in respect of that period for the benefit of the bankrupt's creditors.

It should also be noted that there may also be restrictions for certain professional associations or licensing authorities with respect to a bankrupt person practising in the profession.

### **2.2.4 Overseas travel**

The Bankruptcy Act also requires an undischarged bankrupt to obtain written permission from their trustee in bankruptcy to leave Australia. It is an offence under the Bankruptcy Act to leave Australia without the trustee's written permission.

### **2.2.5 Legal actions**

Under the Bankruptcy Act, any legal action (except for certain limited actions) brought by the bankrupt before the bankruptcy are stayed from the date of bankruptcy until the trustee elects in writing to prosecute or discontinue the action.

## **2.3 Obligations of the bankrupt**

### **Q: What is best practice behaviour for a bankrupt person?**

The bankrupt has an obligation under the Bankruptcy Act to assist the trustee in bankruptcy (even after their discharge from bankruptcy) and provide information reasonably requested by the trustee.

Other obligations of the bankrupt include:

- the bankrupt must attend any meeting of creditors the trustee requires, and give information at the meetings about their conducts and examinable affairs (such as their dealings, transactions, property and affairs as well as financial affairs of their associated entities);
- the bankrupt must give to the trustee all books (including the books of associated entities) which relates to his or her examinable affairs;
- the bankrupt must surrender their passport to the trustee;
- the bankrupt must immediately notify the trustee of any material change that occurred after becoming a bankrupt;
- the bankrupt must immediately notify the trustee of any change in name, address or telephone number;

- the bankrupt must execute such instruments and do all acts in relation to his /her property and its realisation as are required under the Bankruptcy Act or by the trustee;
- the bankrupt must disclose to the trustee as soon as practicable any property he/she acquires before being discharged from bankruptcy if the property is divisible amongst his/her creditors;
- the bankrupt must make contributions from their income if they exceed the income threshold amount;
- the bankrupt must not intentionally provide false or misleading information to the trustee after the date of bankruptcy.

### 3 How to determine if a person is bankrupt?

**Q: What independent documentation can be obtained to ascertain the bankruptcy status of a person in order to make an assessment of whether a person is 'fit and proper' for registration.**

Under the Migration Act, an applicant must not be registered as a migration agent if the Migration Agents Registration Authority ('MARA') considers the applicant is not a 'fit and proper' person to give immigration assistance. One of the matters that MARA must take into account under the Migration Act in considering whether an applicant is a fit and proper person is any present or past bankruptcy of the applicant.

Information in respect of the present or past bankruptcy of any person can be found on the NPII.

The NPII is a public and permanent register maintained by ITSA under the Bankruptcy Act which contains information on personal insolvency proceedings and administrations in Australia. The public can conduct searches for a fee through Index Search Agents on the NPII for the insolvency status of named individuals. A list of Index Search Agents is available on the ITSA website at:  
<http://www.itsa.gov.au/dir228/itsaweb.nsf/docindex/creditors-%3Enpii>

Some of the information which can be obtained from a NPII search includes:

- the name, date of birth, address and occupation of the bankrupt person;
- previous names and aliases;
- the type of proceeding, the date it started and the administration number;
- the name and business address of the trustee or administrator of the proceeding; and
- the current status of the person and/or the proceeding.

The NPII record will also indicate if a bankruptcy has been discharged or annulled.

As discussed above, bankruptcy will also be recorded on the bankrupt's credit file for 7 years from the commencement of the bankruptcy even if the bankruptcy has been discharged.

**Q: Is there particular information that will assist in determining whether the bankruptcy was the result of financial mismanagement rather than environmental circumstances (eg economic downturn)?**

Further, certain personal insolvency documents are available for inspection from ITSA which may assist in determining the circumstances under which the bankruptcy has arisen. However, the documents are only available at the ITSA office in which they were lodged or created, and ITSA charges an inspection fee for the production of the documents. The administration number (which can be obtained from the NPII record extract for the relevant person) is required for ITSA to produce the document.

The documents available for inspection include:

- Statement of Affairs (other than Part A of the form containing certain confidential information) lodged in relation to a bankruptcy
  - an insolvent deceased estate
  - a Personal Insolvency Agreement.
- Documents in relation to a Personal Insolvency Agreement, including:
  - a person's authority granting control over property to a trustee pending an agreement,
  - the person's proposal to creditors
  - the controlling trustee's report on the proposal
  - the agreement that was reached
  - the trustee's consent to administer the agreement
- Documents relating to an examination of a person by the Official Receiver. This may include:
  - the Official Receiver's notes of the examination a recording of the examination
  - a transcript of the electronic recording of the examination (where a transcript was produced at the time of the examination)
- Bankruptcy Notice once a Creditors Petition is presented on the basis of the debtor's failure to comply with that notice.

#### **4 How can a person be released from bankruptcy?**

**Q: If someone is no longer bankrupt and are trying to get back on their feet, what should the client's employees be looking for as signs of success?**

There are two ways in which a bankrupt can be released from his/her bankruptcy, namely:

- discharge from bankruptcy; or
- annulment of bankruptcy.

A bankrupt may obtain automatic discharge from bankruptcy three years from the date of bankruptcy under a debtor's petition or if a bankruptcy has arisen out of a sequestration order, three years from the date of filing of the statement of affairs. When a bankrupt is discharged from bankruptcy, he/she will be

released from their provable debts. However, the bankrupt will not be released from certain debts such as maintenance or child support.

The discharge of a bankrupt may also be objected to by the trustee in bankruptcy at any time before a bankrupt is discharged from bankruptcy. If an objection takes effect, the bankruptcy may be extended for up to eight years.

Further, a bankruptcy may be annulled if all of the debts of a bankrupt have been paid in full, or if the Court is satisfied that a sequestration order ought not to have been made, or in the case of a debtor's petition, the petition ought not to have been presented or accepted by the Official Receiver. A bankrupt may also be able to annul their bankruptcy by compositions and arrangements made via the trustee in bankruptcy with the creditors of the bankrupt.

The NPII record will be updated to reflect the fact that the bankruptcy is discharged or annulled and such information will be recorded on NPII forever.

## 5 Assessing borrowing applications from former bankrupts

### **Q: What would a crediting agency look for if they received a borrowing application from a former bankrupt?**

In terms of assessing a borrowing application from a former bankrupt, you may wish to conduct enquiries to ascertain the circumstances surrounding the bankruptcy. As previously mentioned, personal insolvency documents available for inspection at ITSA may provide details which can be useful in forming an assessment on the former bankrupt.

Other records such as bank statements showing savings patterns of the former bankrupt may also be useful in establishing the current financial situation of the former bankrupt.

In addition, there are strategies which can be adopted by the crediting agency to minimise the risks in borrowing to a former bankrupt. These strategies include securing the loan to the former bankrupt over properties, or requiring a guarantor to guarantee the repayment of the loan. The agency could also consider limiting the size of the loan/credit being given to a former bankrupt.