Chapter 6: The consequences of bankruptcy: Part 6

Updated: 18 September 2024

Content

Summary

There are many different consequences of bankruptcy. Some of the concepts are quite complicated. It is important to have a broad understanding of the principles and to be familiar with problems that might arise so that you know what questions to ask the client and when to seek more advice on their behalf.

This section is broken up into segments. Parts 1 – 5 covers:

1. What happens to debts?
2. What property is protected?
3. What property will be taken by the Trustee?
4. Whether the client has to pay income contributions and how much.
5. What other consequences there might be.

Financial counsellors should be aware of the content of all these parts at least in broad terms as they are relevant to all clients.

Parts 6 – 9 need only be referred to if they are relevant to your client's individual circumstances. They cover in order:

6. Small Business
7. Family Law
8. Gambling and hazardous speculation
9. Death

Introduction

Your client must understand the following potential impacts of bankruptcy before making an informed decision whether to go bankrupt:

- **Debts** – will they go away?
- **Assets** (past, present and future) – will the trustee in bankruptcy ('the Trustee') take them? Can the Trustee undo past transactions and get at assets now owned by others? What about assets your client may acquire in the future?
- **Income** – will the client have to pay a portion of their income towards their debts ('income contributions') and if so, approximately how much?
- What other limitations might there be on the client's life as a result of the bankruptcy?

These are all covered in this Chapter.

> **Note:** The same consequences apply when the client has been made bankrupt on a Creditor's Petition, although in that case there is no decision for the client to make. You can refer to this Chapter to advise your client about what to expect during bankruptcy. You should also refer to the bankrupt's obligations in **Chapter 8**. If your client has very recently been made bankrupt and does not think this should have happened, refer to **Chapter 10** – A sequestration order has been made against my client – Is there anything he or she can do? Advise your client to seek urgent legal advice.

Part 6: Small business and bankruptcy

Summary

Small business bankruptcies present particular challenges for financial counsellors.

Financial counsellors assisting small business clients need to have a working knowledge of the various business models available – sole trader, partnership and company – and the implications of bankruptcy associated with each.

Companies

- insolvent trading
- prohibition on being a Director or otherwise managing a company
- has the company been wound up?

- is the Director personally liable for the debts or not?

Partnerships

- dissolution of the Partnership
- impact on other partners
- AFSA's obligations to refer certain *Debtor's Petitions* by partners to the Court.

Sole traders

- can the person continue in their trade/profession while bankrupt?
- does the Trustee have an interest in the business or its assets?
- will the bankrupt be able to get necessary business insurance?
- requirement to trade under own name (or disclose bankruptcy status to all customers, suppliers etc) if continuing in business,

All

- preferential payments
- requirements to disclose bankrupt status in certain circumstances
- tax implications

Family trusts and tax debts also come up in this area frequently.

Financial counsellors provide a very useful service to many small business clients, particularly when the business is closed and the only outstanding issue is the residual debts. Financial counsellors should nevertheless treat this area with caution and be careful not to take on cases (or issues within cases) that are outside their area of expertise.

Understanding the context

Financial Counsellors are often asked to assist with bankruptcies for clients who have been running small (and sometimes not so small) businesses.

These clients are often experiencing very high levels of stress and relationship strain as the debt burden spills over into other facets of their lives.

When a small business fails it is often the end of a dream. It can be very difficult for clients to let go of the optimism that they had when starting the business. The client may also be facing the loss of their personal assets including the family home and/or the home of a relative (such as their parents).

In many cases the family home has been used as security. Even the family car may be leased by the business. Where appropriate, ensuring that no conflicts of interest exist or are managed appropriately, the financial counsellor could offer the opportunity for the spouse/partner to be present at an interview to ensure the family unit understands the

implications and consequences of bankruptcy.

These clients can be broken down into a number of sub-groups according to the way they operated their business:

- sole traders
- those who have been involved in partnerships
- those who have a corporate structure and may be a director (or the director) of a company

Financial counsellor will need to be aware of the different business structures, the issue of insolvent trading, director penalties, and when it is possible for a small business to continue to function within bankruptcy. Often the client will not appreciate the difference and reviewing documents as well as listening to instructions may be required to understanding the structure.

As a financial counsellor you will need to ask a number of questions to make sure you understand the nature of the business structure (for example – does the client file an Annual Return with ASIC? Does he or she have copies of a Certificate of Registration for GST? Do they lodge a Business Activity Statement? Also, ask to look at their financial statements such as Balance Sheets, Profit & Loss statements and tax returns/notices of assessment, which will provide an insight into the nature of the business structure.)

The categories above can then be further broken down into those who are closing down a failing business; those who are trying to keep a business afloat while personally going bankrupt; and those who are really just self-employed, sub-contractors who want to continue earning a living in this way while bankrupt. Family trusts also come up more frequently among this group of clients. Again, many will have little understanding of a family trust, which will have been formed on the advice of their accountant.

Financial counsellors assisting these clients need to:

- set clear boundaries with what you can and cannot assist with
- refer to lawyers/accountants with specialist expertise
- give clients tailored warnings about particular issues
- get specific advice from AFSA that you carefully file note
- In other cases, you may have to decline to assist a client at all. giving assistance in areas about which you have no real expertise can be worse than no assistance at all. It will also expose you and your service to complaints and potential negligence claims.

Family trusts

Trust issues need expert legal advice.

Trusts are a minefield. Financial counsellors should recommend that the client seeks legal

advice on any trust issues before they assist the client to go bankrupt. The financial counsellor should not purport to advise the client about whether trust assets will be protected from the Trustee. The fact that the client has obtained legal advice in relation to any trust should be recorded in the financial counsellor's case notes.

Sole traders

If someone is a sole trader, they may be responsible for finding work or customers, marketing/advertising, employing people, dealing with suppliers and so on. They may have assets that are associated with or used by the business, and/or significant loans. Examples could include anything from the local corner shop to an interior decorating business.

Other sole traders are really closer to employees but are paid casually and retain responsibility for their own insurance and tax. They have no business assets, no employees and no business debts. The implications of bankruptcy are different depending on where on this spectrum clients are located.

Can a sole trader continue in business after bankruptcy?

This will depend on the nature of the business:

1. If the nature of the business is that of a 'merchant' (that is, buying and selling goods), for practical reasons, the business cannot continue as all the assets of the business (stock, plant & machinery etc) will become assets that the Trustee can take and sell. Furthermore, as soon as new stock and plant & machinery are acquired after the date of bankruptcy, those assets will be available to the Trustee as 'after-acquired assets'. The same could be said of any business which owns significant plant and equipment or other assets. In some cases, the Trustee may allow the bankrupt to continue trading for a short period to enable the business to be sold as a going concern to obtain a return for creditors. This will only occur where the Trustee considers that the business has some value (goodwill) or there is to be a sale of the business assets 'on site' by the Trustee's agent.
2. If the bankrupt is a 'service provider', such as a self-employed tradesperson or consultant with no business-related assets, they may be able to continue trading subject to compliance with a number of obligations under the Bankruptcy Act (and subject to any occupational restrictions imposed by the appropriate licensing authority or professional association).

Specifically, the client would have to take care not to breach s 269 which requires that the bankrupt person disclose their bankrupt status to the other relevant party (for example, creditor or supplier) in any of the following circumstances where the amount involved exceeds the applicable threshold, $7,032 as at 18 September 2024 (for current indexed amounts check the AFSA website):

- when obtaining credit

- when obtaining goods or services from a person:
  - by giving a bill of exchange or cheque drawn, or a promissory note
  - by giving 2 or more of the above which add up to more than the threshold
- when entering into a hire-purchase agreement or a contract or agreement for the leasing or hiring of any goods
- when obtaining goods or services on credit
- when promising to supply goods or render services.

It is also an offence to carry on a business under an assumed name, in the name of another person, or under a business name (in all cases whether in partnership or not) without disclosing to every person with whom he or she or the business deals his or her true name and the fact that he or she is an undischarged bankrupt. If the person is in business in his or her own name (the same name as appears on the bankruptcy documentation), then compliance with the dot points above only is required. It is recommended that a bankrupt trades in his or her own name for this reason.

> **Note:** If the client is in a trade, licensed occupation or profession, there may be limitations placed on their ability to continue in this work while bankrupt imposed by other regulators or professional bodies (see **Chapter 6 Part 5**).

From a practical perspective, the reason for the bankruptcy is crucial to whether the person can realistically continue in business. If the bankruptcy has been caused by a one-off event not associated with the business, such as a family breakdown, an uninsured car accident, or legal costs from an unsuccessful court case, continuing the business may be feasible if the Trustee approves, or has no interest, and the client can overcome the considerable practical hurdles above. On the other hand, if the reason for the bankruptcy is that the business itself has been a losing concern, the client cannot realistically expect to continue.

If the client has an existing ABN when he or she becomes bankrupt, the Trustee will advise the Deputy Commissioner of Taxation of the bankruptcy. The Tax Office will note the date of the bankruptcy against the ABN. The client will need to contact the Tax Office and arrange to have the ABN reactivated if they want to continue using it or obtain another ABN. There is no restriction on applying for an ABN after becoming a bankrupt.

If the client is registered for GST and wishes to continue in their trade or profession during bankruptcy, he or she should advise the ATO so that their pre-bankruptcy GST liability (if any) can be separately identified. Any pre-bankruptcy GST will be provable in the bankruptcy, including ATO imposed penalties for late payment. However, if the ATO opted to prosecute, any Court imposed fines would not be provable. Regardless of bankruptcy, the client will still be responsible for lodging Business Activity Statements if they have an active ABN and are registered for GST.

Whether the client continues to be self-employed or not, he or she will be subject to the *income contribution* regime (see **Chapter 6 Part 4**).

When the business is being closed down

This is the most common scenario faced by small business people approaching financial counsellors. The client is usually very stressed and has been scrambling to try and stay in business for some time. Paperwork is often the last thing on their mind; the accounts are often incomplete; and tax is in arrears. There may also be lease payments that are in arrears.

The loss of monies invested in the business by other local businesses, family members and friends is a huge issue for these clients. These clients will need access to a range of support services to manage the level of stress and isolation this can bring.

Preferential payments

This is a perennial problem when businesses are in trouble. Quite often the business will pay the most pressing creditors and/or debts for essential services to try and stay afloat. If they subsequently go bankrupt those creditors who have been recently paid may find the Trustee wanting to claw back those payments (see **Chapter 6 Part 1**).

When faced with a small business operator who is facing the very real prospect of bankruptcy it is the duty of the financial counsellor to make this issue very clear. This is often very stressful for the client as they often want to pay out a creditor with whom they have a positive relationship, including a family member or friend. The client should also understand that they can pay back the friend or family member from their income during bankruptcy or after discharge (there may of course be practical problems like insufficient money, keeping in mind the possibility of *income contributions* being required).

Undervalue transactions & transactions to defeat creditors

When a business is trying to stay afloat the client will often dispose of business assets to keep up the cash flow or to protect them from seizure by the Sheriff ‘s officers. Where the goods are disposed of for market value this is unlikely to be a major issue within bankruptcy. But where the goods are sold for a nominal amount, or simply signed over for no consideration, then the Trustee will investigate and may take recovery action against the person who received the assets (see **Chapter 6 Part 3**).

Often the client will have sought legal advice on disposing of goods to avoid civil debt recovery action without seeking advice on the consequences of such action if they go bankrupt.

The time that this transaction took place is also very important; the closer it is to the bankruptcy the greater the issue (refer to the section **How far back can the Trustee look to claw back property for the bankrupt’s estate?**

in **Chapter 6 Part 3**)

Business records

These should be brought up to date where possible to simplify the bankruptcy and give the client a greater sense of closure. This is not always possible, especially where the accountant or solicitor is a potential creditor in the bankruptcy. Where no business records are available the client should seek advice from AFSA about what the Trustee will require.

Failure to keep proper books of account in the five years prior to the bankruptcy or failing to preserve such records is also an offence under s 270, potentially punishable by imprisonment. There is a defence, however, that the failure to keep or preserve the books was 'honest and excusable'. The potential sentence increases where the bankrupt has previously been bankrupt or entered another form of insolvency arrangement such as a Personal Insolvency Agreement or Deed of Arrangement. The likelihood of prosecution for such an offence is remote, and usually only occurs in conjunction with other alleged offences.

Tax debts

Most small businesses that fail have outstanding tax returns and/or tax debts. While it is not a requirement of bankruptcy that the outstanding tax returns be lodged before going bankrupt, it will make the bankruptcy less stressful for the client. Plus, it will avoid action being taken against the client by the ATO in respect of the non-lodgement of those tax returns.

Where the business is closing partway through the financial year it may be beneficial to lodge two returns, one up to the day before bankruptcy and a second for the period from the date of the bankruptcy to the end of the financial year. Any debt arising from the first return will be provable in the bankruptcy (and any tax refund will vest in the Trustee). Any debt arising from the second return will not be provable and any refund will be counted as income for contribution purposes (or kept by the ATO and set off against any amount owing to the Commonwealth such as Child Support, Centrelink, etc).

Commercial Leases

The client must be careful to include details of any lease of premises and/or vehicles and plant & equipment in the statement of affairs. The Trustee will normally disclaim a lease of premises as the Trustee becomes personally liable for the liability under the lease. If the client has been permitted to continue trading by the Trustee, they will need to negotiate with the landlord as to their continued occupation of the premises.

The lessor may have locked the client out and taken possession of business equipment.This will largely be a matter to be sorted between the Trustee and the lessor but if the client believes there are protected tools of trade on the premises they should inform the Trustee.

The Trustee does not disclaim leases on vehicles and plant & equipment. It will be a matter for the client to negotiate with the finance company concerning their continued possession and use of the leased asset if required. If the lease is up to date, then there should be no issue. Section 301 of the *Bankruptcy Act* provides that any provision in a lease, contract or hire-purchase agreement which purports to change the agreement, terminate the agreement or allow repossession in the event of bankruptcy is void. However, the client should be advised to contact the finance company, preferably before it receives notification of the bankruptcy from AFSA, to avoid any chance of an employee in the finance company who is unaware of the effect of Section 301 starting repossession action. See **Chapter 8** for more information in the event that repossession action is threatened.

Partnerships

The issue of partnerships and bankruptcy has two major facets for financial counsellors:

- is your client the partner who is going bankrupt?
- is your client's partner going bankrupt?

> **Note:** All of the above information in relation to preferential payments, undervalue transactions, tax debts and business records may also apply in the case of partnerships.

Your client is going bankrupt

When a partner becomes bankrupt the partnership is dissolved unless there is specific provision in the partnership agreement stating that bankruptcy does not dissolve the partnership (these clauses are rare). The bankrupt's interest in the partnership is an asset of their bankrupt estate (and therefore vests in the Trustee).

It is also possible for members of a partnership to present a joint Debtor's Petition againstthe partnership. This can be done by all members of the partnership or a majority ofmembers resident in Australia. A Debtor's Petition filed by some, but not all, members of apartnership must be referred to the court by AFSA (s 56C(1)(a)). A Debtor's Petitionpresented against a partnership must also be referred to the Court if there is a Creditor'sPetition pending against one or more but not all of the partners (s 56C(1)(b)). If all of thepartners file a Debtor's Petition and there is a Creditor's Petition against all of them, thenthere is no need to for AFSA to refer the matter to the Court. Similarly, if all the partners filea Debtor's Petition and there are no Creditor's Petitions against any of them, then there is noneed for AFSA to refer the matter to the court.

The situation of one partner entering bankruptcy is very similar to that of a jointly owned home where one of the joint owners becomes bankrupt – the Trustee will invite the non-bankrupt partner to either make an offer to purchase the bankrupt's interest in the partnership or wind up the partnership (that is sell the partnership assets, pay the partnership debts and make a return of capital to the partners representing their share).

The partnership agreement is an important document as it will detail the proportions in which the partners hold an interest in the partnership (that is their respective shares) and should detail how the surplus in a winding up is to be distributed.

If the non-bankrupt partner declines to take either option above, and it is commercially viable to do so, the Trustee will have the court appoint a receiver to wind up the partnership and make a distribution of capital.

Sometimes problems arise determining the ownership of personal assets (such as motor vehicles, tools, etc) used in the partnership business, which need to be resolved by the Trustee in conjunction with non-bankrupt partner.

The bankruptcy of the partner may cause huge interpersonal issues with the other partners especially if they are personal friends or relatives. The financial counsellor can do little more than warn the client about this. The client may have little choice in any event depending on their personal circumstances.

Your client's business partner is going bankrupt

When your client's business partner becomes bankrupt the partnership is dissolved (unless the agreement provides otherwise). This will happen even if the ex-business partner's debts have nothing to do with the partnership.

This will mean that your client will be dealing with a Trustee of the bankrupt estate of the bankrupt partner in relation to the ex-partner's interest in the business. This could result in the Trustee looking to realise the ex-business partner's interest in your client's business to satisfy the ex-business partner's liabilities.

Where a business partner is considering bankruptcy, the solvent partners may wish to consider satisfying the personal debts of the partner facing bankruptcy to protect the partnership.

Where your client is facing the scenario of a business partner going bankrupt, they should be referred to independent legal advice. This is NOT an area where financial counsellors can play a significant role, except in picking up the pieces in the usual way if the dissolution of the partnership leaves the client with insufficient income to meet his or her own personal debts.

Directors and companies

When a client approaches a financial counsellor about their business issues there are a number of key issues that the client will need to consider if they are a director of a company.

a. Where client's business is being operated by the company and its failure is the cause of the bankruptcy

Insolvent trading

Generally, a company is insolvent if it is unable to pay all its debts when they fall due. A director has a positive duty to prevent insolvent trading under s588G of the *Corporations Act 2001* (The Corporations Act).

Safe harbour provisions contained in ss 588GA and 588GAAB of the *Corporations Act* came into effect on 19 September 2017.

There are two main issues with insolvent trading:

1. The director commits a breach of the *Corporations Act* if they allow the company to continue to trade whilst insolvent. Accordingly, the financial counsellor needs to make the client aware of the insolvent trading offence and file note that he or she has done so. It is likely that the client may already have breached these provisions. Section 588G of the *Corporations Act* sets out two levels of contravention:
    1. firstly, a civil penalty provision (fine) applies to a director who fails to prevent a debt being incurred where he or she is aware that there are grounds for suspecting insolvency, or where a reasonable person in a similar position would suspect insolvency; and
    2.

secondly, there is a criminal offence committed where:
- a director suspected at the time a company incurred a debt that the company was insolvent or would become insolvent as a result of incurring that debt; and
- the director's failure to prevent the company incurring the debt was dishonest.

2. The director can become personally liable for all the debts of the company if they allow it to trade whilst insolvent. The liquidator of the company will normally lodge a proof of debt on behalf of all the company creditors with the Trustee of the bankrupt estate of the director.

For more information on insolvent trading, you can refer the client to ASIC Regulatory Guide 217 **Duty to prevent insolvent trading: Guide for directors** . (Note as at January 2024 the Guide was being reviewed, and so ensure to review the latest Guide**).**

If your client has ongoing questions and concerns, you will need to refer them for legal advice as it is a difficult and not well understood area in relation to the safeguards.

Directors guarantees

Despite the belief that a company structure will protect directors from the company debts, creditors will often require a personal guarantee from the director(s), particularly if the business has no significant assets of its own. The personal guarantee will normally contain a clause that the director grants a charge over their interest in all their current and future real property (that is the creditor of the company is given a charge over the director's home, investment property, holiday home etc) as security for the company's debt which the courts will enforce in the event that the company does not pay the debt.

If the client has signed a director's guarantee, he or she will be personally responsible for the debts (or jointly and severally liable with others). These guarantees are what often turn a business debt issue into a personal debt issue. Bankruptcy will only be useful in circumstances where the debts outstrip the assets taken as security.

Note: Directors are personally liable for any company liability in relation to un-remitted tax deductions from the wages of company employees and as from July 2012 directors also became personally liable for any company liability in relation to un-remitted superannuation contributions in respect of company employees. These debts are provable in bankruptcy.

Winding up the company

Where a company is in financial difficulty, the Director or Directors should seek independent

legal and accounting advice. If there is no way out of the predicament, the company will have to appoint a voluntary administrator or liquidator. This is **NOT** the role of the financial counsellor. For more information see ASIC website.

If the client has no personal debts and has not signed a Director's Guarantee they may not need to go bankrupt subject to insolvent trading and tax and superannuation liability considerations as detailed above.

Where there are significant personal debts as a result of the failure of the business, including as a result of guarantees, then bankruptcy may be appropriate. If possible, the company should be wound up first so that all the debts can be crystallised. However, if clients are facing urgent enforcement action in relation to personal liabilities this may not be possible. Providing the company has stopped trading and incurring liabilities this should not present a problem because the debts will be existing or contingent liabilities at the date of the bankruptcy.

In some cases, the client will not have the funds to engage an insolvency practitioner to wind up their company. The client should be advised to contact ASIC to ascertain their options. Generally, if the company does not lodge the requisite returns, ASIC will de-register the company after a certain period of time. Whilst there are penalties for directors not lodging the requisite returns, it is unlikely that ASIC will take prosecution action against a bankrupt director.

b. Where the client happens to be a Director of another business or organisation unrelated to the debts

A person may be a Director of a solvent company operating a family business but be going bankrupt because of personal debts. Alternatively, he or she may be a Director on the Board of another organisation, in addition to his or her usual occupation. In either case, the person is disqualified from being a Director from the date of the bankruptcy under the provisions of the Corporations Act. For more details on this and what has to be done by the bankrupt and the company on which they used to be a Director see **Chapter 6 Part 5**.

In the case of the family business, then the client must particularly note that it is not enough to appoint an alternative director – they must remove themselves from all aspects of management of the business and influence (or perceived influence) over the continuing directors.

De-registration

If the client is going bankrupt because of personal debts but can no longer be the sole director of his or her own company (because of automatic disqualification) the company may be eligible to be simply deregistered:

- all members of the company must agree to the deregistration; and

- the company must not be carrying on business; and
- the company's assets must be worth less than $1000; and
- the company must have paid all fees and penalties payable under the Corporations Law; and
- the company must have no outstanding liabilities; and
- the company must not be a party to any legal proceedings.

The client needs to lodge Form 6010 Voluntary deregistration of a company with ASIC.

What if your client wants to start a new business while still bankrupt?

Where a client is seeking to continue in business or start up a new business while bankrupt, they should seek independent legal and business advice. They should also discuss their plans with AFSA, the Trustee and the ATO to prevent potential offences being committed. A company structure will not be available until the client has been discharged from bankruptcy.

Alternatives to bankruptcy

- In certain circumstances it may be possible to avoid bankruptcy and keep the sole trader business operating by entering in a Personal Insolvency Agreement (PIA) under Part X of the Bankruptcy Act. A proposal could be put to creditors that the client retain their business assets (and their home if there is little equity in it) and in return the business will pay a fixed amount each month to the Trustee of the PIA (and possibly a % percentage of the net profit each year) for a period of say 3 – 5 years. They may also be able to offer other personal assets such a block of land or investment property. See **Chapters 5 and 12 for more information about PIAs.**
- Likewise, if the client's assets, liabilities and income do not exceed the Debt Agreement limits under Part IX of the Bankruptcy Act, they may be able to have the creditors accept a Debt Agreement. The costs of administering a Debt Agreement are usually lower than those of a PIA due to fewer statutory obligations on Debt Agreement Administrators compared with Registered Trustees. **For more information about Debt Agreements see Chapters 5 and 11.**

  Note: One advantage with a *Debt Agreement* is that the client is not disqualified from being or becoming a director of a company by entering into a Debt Agreement.