Chapter 10: Help, I’m being made bankrupt! Part 1

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Summary

This chapter describes the process for making a debtor bankrupt through the courts. It describes the process and your client’s options at each stage.

This is an area where proceedings move fast and legal costs accumulate quickly. If you have a client who has received a Bankruptcy Notice or a Creditor’s Petition, they will need urgent legal advice.

If your client has already been made bankrupt, the first they hear about it (or the first time they are driven to take action) may be when the Trustee freezes their bank account(s). Again, it is important to get advice urgently because there are short time limits for taking action and Trustees costs add up fast.

If your client has been made bankrupt, they need to file a statement of affairs as soon as possible, whether they intend to try to get the bankruptcy set aside or not!

Key terms

Bankruptcy Notice

This is a document issued by the Official Receiver when a creditor applies (and pays the filing fee) and can prove that there is an outstanding judgment (or judgments) against a debtor for $10,000 or more. The judgment(s) must not have been stayed by the court and must not be more than 6 years old. The notice itself does not start any court proceedings. Failure to pay within the time provided is an act of bankruptcy (see below) on which a creditor may then base a Creditor’s Petition.

Creditor’s Petition

This is a formal application to the court to make a debtor bankrupt. This commonly follows an unpaid Bankruptcy Notice (although theoretically there are other acts of bankruptcy on which it could be based – see **Chapter 10 Part 3**). The act of bankruptcy must have occurred in the previous 6 months. There will always be a hearing within a very short time and the debtor must attend or apply to the court for an adjournment if he or she is to have any hope of avoiding bankruptcy.

Sequestration Order

This is an order of the court making a person bankrupt. Most commonly this will be the result of a Creditor's Petition. Your client's options are very few once they have been made bankrupt. Those options they do have are canvassed later in **Chapter 10 Part 4**.

Part 1: Introduction

While voluntary bankruptcy is the most common way that debtors become bankrupt, a number of debtors are threatened with forced bankruptcy each year for non-payment of debts.

Bankruptcy has serious consequences for debtors, many of whom have assets to lose, most commonly the family home, a vehicle or perhaps a mobile home/caravan which serves as their home. The threat of Trustee's fees, which can amount to tens of thousands of dollars in a relatively short period of time, and legal fees, also means there is much more at stake than the amount of the debts. A debtor who is not really insolvent but ignores the bankruptcy process (often because they don't know what to do), can end up with nothing left by the time the bankruptcy is annulled, or insufficient funds to annul the bankruptcy. This means that they may not only lose their home and other assets, but they are also subject to the same restrictions as all bankrupts in terms of their opportunities to travel, to enter loans, to be a company director etc.

While it is important that the law has a mechanism for dealing with insolvency, the results for debtors can sometimes be punitive and disproportionate. While bankruptcy is not supposed to be a substitute for debt collection, many financial counsellors and consumer advocates are aware of creditors and debt collectors who routinely resort to bankruptcy without exhausting other debt enforcement mechanisms first. Using the bankruptcy process to collect unpaid strata management fees has become particularly common and many clients who present as experiencing mortgage hardship are often also at serious risk of facing bankruptcy proceedings in relation to unpaid strata management fees.

It is very important to act fast when your client may be at risk of being made bankrupt. For a client facing bankruptcy, a day or two can make a world of difference. If your client says anything or gives you any documents that indicate they are facing bankruptcy proceedings, or have been made bankrupt, you should refer the client for urgent legal advice.

Case study

A financial counsellor had a client who had been hospitalised for many months due to her mental health. Upon being released the client found she had a demand to pay $12,000 in strata management fees. She paid immediately, but it was all the money she had. Later she received a demand from a lawyer for costs. The letter claimed over $3,000 in legal costs, including amounts for the issue of both a *Bankruptcy Notice* and a *Creditor's Petition*. The financial counsellor was very concerned the client may have already been made bankrupt. She contacted Financial Rights Legal Centre (Financial Rights). A Financial Rights' solicitor searched for the client's case on the Commonwealth Courts Portal and discovered that the *sequestration order* had not been made (because the client had paid the original debt) but that the Court had ordered the financial counsellor's client pay legal costs and specified the amount. If the *sequestration order* had been made, the client would have had only 21 days from the date of the decision (which may have been weeks ago) to have the decision reviewed! The financial counsellor did the right thing by seeking assistance immediately.

Bankruptcy proceedings will usually take place in the Federal Circuit and Family Court of Australia (FCFCOA) or the Federal Court of Australia (FCA) for debts of very large amounts (or for the convenience of the creditor's solicitor), as both courts have exactly the same original jurisdiction under the Bankruptcy Act. The Registrar assigned to bankruptcy hearings on the day will hear matters for both courts. Bankruptcy proceedings are very technical and are very expensive. To make matters worse, it is not a particularly 'debtor-friendly' jurisdiction – there is less scope for courts to be sympathetic to debtors once bankruptcy proceedings have begun. There is also a risk of additional costs being ordered against your client at every turn. If your client agrees they owe the debt, or most of it, then they should pay as much as they can, as soon as possible, and keep negotiating for time to pay off the rest, if necessary, at the same time as getting legal advice.

The rest of this Chapter will refer to the Federal Circuit and Family Court of Australia (FCFCOA) (formerly the Federal Magistrate's Court and the Family Court of Australia). However, in some cases the relevant court will be the Federal Court of Australia.

Hint for lawyers

This jurisdiction is very technical – do not put your toe in without being aware of the relevant provisions and clauses in:

- *Bankruptcy Act 1966*
- *Bankruptcy Regulations 2021*
- *Federal Circuit and Family Court of Australia Act 2021*
- *Federal Court and Federal Circuit and Family Court Regulations 2022*
- *Federal Circuit and Family Court of Australia (Division 2) (Bankruptcy) Rules 2021*
- *Federal Circuit and Family Court of Australia (Division 2) (General Federal Law) Rules 2021* (which apply where there is no specific coverage of the issue in the bankruptcy specific rules above
- The Federal Circuit Court Practice Directions
- AFSA Practice Statements.

If the matter is in the Federal Court of Australia, then the Federal Court (Bankruptcy) Rules 2016 and Federal Court Rules 2011 will apply. The Bankruptcy rules in both FCFCOA and FCA are harmonised and are generally of the same effect but check the rules of the specific jurisdiction.

The *Bankruptcy Act* & Regulations and the Court Rules are amended from time to time in significant ways. Lawyers should use the Federal Register of Legislation website or the Federal Circuit and Family Court of Australia website to make sure they are referring to the correct instruments for the relevant point in time.

Acts of bankruptcy

A key concept in the *Bankruptcy Act 1966* is that a person who commits an act of bankruptcy is then vulnerable to bankruptcy proceedings – that is an application by a creditor, or group of creditors, to make the person bankrupt.

There are many acts of bankruptcy. A comprehensive list of acts of bankruptcy is found in s 40 of the Act. Some of these are alarmingly broad. The most commonly relied on act of bankruptcy, however, is in s 40(1)(g) and is based on an unsatisfied judgment debt, followed by an unsatisfied Bankruptcy Notice. Bankruptcy Notices are covered in detail in **Chapter 10 Part 2**.

Examples of acts of bankruptcy (see s 40(1)):

- filing a Debtor's Petition
- filing a Declaration of Intention to present a Debtor's Petition
- filing a Debt Agreement Proposal
- breaching a Debt Agreement
- disappearing, leaving the country, failing to respond to attempts at contact – all with the intent to defeat or delay creditors
- giving notice to any of his or her creditors that he or she has suspended, or that he or

she is about to suspend, payment of his or her debts* (see Note below)
- making a conveyance or assignment for the benefit of creditors generally
- making a conveyance, transfer, settlement, or other disposition of property, creating a charge on property, or making a payment or incurring an obligation – any of which would be void against the Trustee if the person went bankrupt
- a court has issued an order or writ for execution against property which has since been sold or held by the sheriff for 21 days, or the execution remains unsatisfied
- if a s 188 authority is signed appointing a controlling trustee (this is the first step in entering a Personal Insolvency Agreement – see **Chapter 5**)
- a Personal Insolvency Agreement, composition or scheme of arrangement is terminated or set aside by the court.

***Note:** It is sometimes observed that financial counsellors may be assisting clients to commit an act of bankruptcy when writing to creditors about their financial difficulties and requesting alternative repayment arrangements. While it would not hurt for financial counsellors to be careful in their choice of language – do not directly state than clients will or have ceased paying their debts, for example – there is no real cause for alarm on this count. Creditors prefer to rely on clear cut acts of bankruptcy that are easy to prove. As noted above, failure to pay in accordance with a Bankruptcy Notice issued in relation to a judgment debt is overwhelmingly the most common basis for a *Creditor's Petition*. Terminated PIAs and *Debt Agreements* also lead to sequestration orders (bankruptcy) in some cases. There is no known case of a financial counsellor's hardship letters being used to establish an act of bankruptcy.

The process for making a debtor bankrupt

Following final judgment, if the debt is not paid a Bankruptcy Notice is served (see **Chapter 10 part 2**). These steps detail the process from Bankruptcy Notice to a client being bankrupt.

Step 1: Bankruptcy Notice served

- **What can you do?**

    1. Apply to set aside Bankruptcy Notice
    2. Apply to extend time to comply

    - **IMPORTANT:** DO NOT do this without legal advice. This is a very technical procedure – it is not about general fairness but technical compliance. Your client will have to pay costs if they are not successful. If you client wants more time to pay, negotiate directly with the creditor or get the client to apply to pay by instalments at the original court and start paying!

- **What might happen to your applications?**

    1. **Application Granted =** The client must now deal with the outstanding debts as required by the Court, for example, challenge them in the appropriate jurisdiction, negotiate the amount or the timeline or create a payment plan. This will depend on what sort of application was made.
    2. **Application Dismissed = Go to Step 3**

Step 2: Bankruptcy Notice not paid

If not paid within the time given (usually 21 days), this is an Act of Bankruptcy and your client moves to Step 3.

Step 3: Creditor's Petition served leading to a Creditor's Petition Hearing.

- **What must your client do now?**

    1. Your client MUST turn up to the court for the Hearing (known as a Sequestration Hearing).
    2. Now is the opportunity to try to get more time to pay the debts. The court will usually allow one or more adjournments to allow the parties to 'work things out'. If your client has applied to pay by instalments, set aside the original judgment or appealed the decision, they still need to turn up and inform the court (with evidence).

- **What might happen at the Hearing?**

    1. **Petition Dismissed =** while a petition dismissal means the client is NOT declared bankrupt, it is important they deal with the pre-existing debt, as previously required, to avoid further consequences
    2. **Petition Granted = Sequestration Order made = your client is now BANKRUPT**

- **Is there anything else you can do?**
    - Apply for Review of a Registrar's decision (21 days) or Appeal from a single Judge of FCA or FCFCOA

Steps to avoid being made bankrupt

It gets more and more difficult to avoid bankruptcy as the process progresses.

The best thing your client can do to prevent bankruptcy is avoid a judgment debt in the first place. It is essential to respond to a statement of claim (or other initiating process) in the Local/ District/Supreme Court or other court to avoid a 'default judgment'. If the credit

provider is in the Australian Financial Complaints Authority (AFCA) or another External Dispute Resolution service (for telecommunication or energy)), you can lodge in the scheme to stop legal proceedings progressing, but this will only provide you with a limited reprieve.

If the debt is owed, you need to keep negotiating and making payments to reduce the debt. Make sure any negotiated resolution is realistic for your client and emphasise the importance of the client sticking to the arrangement. As far as possible, avoid agreeing to judgment being entered as part of the resolution as this will leave your client vulnerable to bankruptcy proceedings in the event they breach the arrangement. AFCA may not require the financial firm to discontinue proceedings if they were appropriately instituted. If you believe they were not, seek advice.

If judgment has already been entered, then the client needs to pay the amount claimed in full or to get enforcement of the judgment or order stayed in the court where the original judgment was made prior to the issue of a Bankruptcy Notice. Your client can lodge in AFCA after a judgment but before a bankruptcy notice to assist in negotiating a payment arrangement, but AFCA's jurisdiction is very limited to a payment arrangement. It does not technically stay any judgment.

Only a stay issued by the court, however, will prevent a Bankruptcy Notice being issued or render it invalid. In most jurisdictions an **application to pay by instalments** will result in a stay of enforcement, although you may have to specifically apply for a stay (especially with second and subsequent applications). Check the rules in your jurisdiction or get legal advice. Your client should pay what they can immediately (regardless of any application to pay by instalments) and confirm any arrangement agreed with the creditor in writing.

If a debtor makes an application to pay by instalments it is important that they start paying in accordance with the proposed instalment plan immediately, regardless of whether they have been notified of the court's decision in relation to the application. Similarly, if a creditor lodges an objection to an instalment order, the debtor should keep paying until the objection has been dealt with by the court.

If your client believes the debt is not owed (that is that the client has a defence) or the client has a possible cross claim, the client should seek urgent legal advice, whether or not judgment has been entered. It may be possible to get the judgment set aside.

Applications to pay by instalments

The process for applying to pay a *judgment* debt by instalments varies between all the States and Territories of Australia. Financial Counsellors will generally be familiar with their local process and may even have knowledge of the idiosyncrasies of their nearest court(s).

Generally speaking, there are two ways in which clients go wrong when

preparing an application to pay by instalments:

They complete the income and expenditure form in such a way that it does not reveal sufficient income to meet the instalments offered (in other words they show a big shortfall between income and expenditure). They believe that they need to convince the court that they are very poor so that the court will agree to the order. Unfortunately, the court will not agree to the order if it appears that the debtor cannot afford to meet the instalments.

AND/OR

They ask for such low instalments that the debt will not be paid off within a reasonable time. Again, the courts will vary as to what they consider to be a reasonable time, and sometimes even change their approach according to whether the creditor is an institution such as a bank, or an individual or small business. Asking for instalments which will pay off the debt in less than three years is generally a good guide.

If the client really cannot afford the instalments they are offering, or they cannot afford to pay off the debt within a reasonable time, they may need to sell property in order to pay the debt and avoid bankruptcy. If they do not have any property, you can try to convince the creditor that they are wasting their time and money enforcing against the debtor.

As noted above, an application to pay by instalments will only stop bankruptcy proceedings if it is accepted, and a stay of enforcement granted, **prior** to the issue of a *Bankruptcy Notice*. Any breach of the instalment order will also mean that the stay ceases to have effect and a *Bankruptcy Notice* can be validly issued. You can still apply to pay by instalments after the issue of a *Bankruptcy Notice*, but it will not prevent the creditor filing a *Creditor's Petition*.