Chapter 10: Help, I’m being made bankrupt! Part 3

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Content

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 3: Creditor's Petitions

A creditor can present a Creditor's Petition against a debtor if:

- the debtor has committed an act of bankruptcy within the preceding 6 months (s 44(1)(c))
- the debtor owes the creditor at least $10,000 or in the case of a joint petition by 2 or more creditors, the debtor owes a total of $10,000 when the debts to each creditor are added together (s 44(1)(a))
- the debts are liquidated sums due at law or in equity (or partly in each) and are owed immediately or at a certain future time.

A secured creditor can only be counted to the extent that the debt owed to them exceeds their security (the amount of the estimated shortfall) unless they are willing to agree to surrender the security for the benefit of all the debtor's creditors.

The Creditor's Petition must be filed in the Federal Circuit and Family Court of Australia or the Federal Court of Australia. The creditor must pay the cost of filing the application, but the costs may ultimately be paid out of the estate as a priority if the debtor is made bankrupt (ss 51 and 109). A Creditor's Petition cannot be withdrawn after presentation except with the leave of the court (s 47(2)).

The Creditor's Petition will be listed for hearing by the court. The Creditor's Petition must be served on the debtor along with a copy of the affidavit(s) verifying the petition (proving the required facts), and any other relevant documents, at least 5 days prior to the date fixed for the hearing of the Creditor's Petition. Creditor's Petitions need to be 'personally served' unless a Court has made an order permitting substituted service. These orders are often made when a debtor appears to be deliberately avoiding service, and can permit service by post, email and even text message to the debtor's mobile phone or social media post.

At the hearing the creditor will need to prove to the court's satisfaction that (s 52(1)):

1. the matters stated in the Creditor's Petition are true (that is that debtor has committed act of bankruptcy in last 6 months and that at least $10,000 is owed now or at some future definite time)
2. that the Creditor's Petition has been served on the debtor as required
3. that the debt or debts on which the petitioning creditor(s) rely are still owed.

A Creditor's Petition will lapse after 12 months unless, prior to the expiry of the 12 months, the creditor applies for an extension of time (s 52(4)). The Court can only give a maximum of another 12 months (2 years in total) to prosecute the petition (s 52(5)).

My client has been served with a Creditor's Petition – What now?

Your client still has options at this stage and the most important thing is not to ignore the Creditor's Petition. At the first return date (the first time the matter is in court) the matter will be listed before a Registrar. The client may get as few as five days' notice of the hearing but MUST attend the hearing at the Court on the appointed day unless they are happy to be made bankrupt. If the client really cannot attend, they should contact the court giving reasons and attaching evidence, and/or seek to appear by phone or instruct a solicitor to attend.

Your client has three options:

1. seek an adjournment (either to get advice or to pay or both); or
2. file a Debtor's Petition; or
3. oppose the Creditor's Petition.

The court can make a sequestration order (an order making the debtor bankrupt) if the court is convinced of the 3 matters required to be proved by the creditor (see above – s 52(1)). However, if the court it is not satisfied of those matters, or it is satisfied by the debtor that either:

1. the debtor can pay their debts (solvency); or
2. there is other sufficient cause that the order should not be made.

Then the court may dismiss the petition (s 52(2)).

Seeking an adjournment

In many cases your client's best hope at this stage will be to attend the court and seek an adjournment under s 33 of the *Bankruptcy Act.* If your client has paid off a substantial portion of the debt and has a plan to pay the remainder within a few months, then evidence of this should be provided. If your client has property that they are willing to sell, they will need to provide evidence of this, such as a contract for sale and a real estate agent agreement. If your client has tried to pay and the creditor won't accept the money, then the client should also seek an adjournment for the purpose of negotiations and advice. If your client needs legal advice, they should indicate this and describe what they have done towards getting an appointment.

If your client really cannot attend on the nominated hearing date, they can apply for an adjournment in writing. Ideally the application for an adjournment should be supported by an affidavit, with supporting materials attached and filed as soon as possible (although it is better to get something to the court than nothing). The client will need to have a very good reason and provide evidence (such as a medical certificate indicating they are in hospital or recovering from a very recent operation). The court will generally only give short adjournments (1 – 4 weeks). If possible, the client should arrange to be available by telephone. An application to attend by telephone can be made by completing and filing the appropriate form within the required timeframe (refer to the Court's website).

Any adjournment will be for a limited time and your client will need to keep showing up to argue on future court dates if they need further time. It will be fairly easy to get an adjournment on the first date set for hearing the Creditor's Petition if your client has an arguable case, or just needs time to get advice or pay the debt. But it will be increasingly difficult to obtain a further adjournment on each subsequent occasion. Many Registrars operate on a rule of thumb that a bankruptcy case should receive no more than two adjournments without a very good reason. The creditor's legal costs will also increase with each court appearance, which the client may eventually be ordered to pay.

If your client may have grounds to oppose the Creditor's Petition (see below) or has a case for setting aside or appealing the original judgment, they will need to get legal advice. Usually, the court will give an adjournment for this purpose.

If your client does lodge an appeal or set aside application (in the original court) and successfully stays the judgment, this will NOT undo the act of bankruptcy already committed (failure to pay in accordance with the Bankruptcy Notice) – the only way to prevent this is to apply for an extension of time to comply with the Bankruptcy Notice before the time to pay expires. However, it may provide grounds for the court to adjourn or dismiss the Creditor's Petition. (Another creditor [or creditors] could nevertheless rely on the original act of bankruptcy if they are separately owed more than the required $10,000 and seek to be

substituted as the petitioning creditor (s 49)).

In seeking adjournments, it is important for the debtor explain to the court:

- why the adjournment is necessary to be fair to the debtor in the circumstances; AND
- why the adjournment will not prejudice the rights of the other party.

It is important to remember that the Creditor's Petition will expire after 12 months. The court can, on the application by the creditor, extend it for another 12 months but no longer. The court is unlikely to allow adjournments to continue for long periods without very good reasons.

Case study

A woman in her late eighties contacted the Credit and Debt Legal Advice line at Financial Rights Legal Centre because she had been served with a Creditor's Petition. She rang on a Friday morning and the Creditor's Petition was listed for hearing on the following Monday. She owned a small flat in an expensive part of Sydney. The paperwork alleged that she had obtained a loan. She had no recollection of the loan and did not receive any money. She said that it was something to do with her son. He had assured her that he was 'fixing' everything, but she thought she would just get a little advice of her own. The original loan was for $60,000 and the amount now claimed exceeded $100,000.

Had a sequestration order been made by the Court, she would have been made bankrupt, her home and only asset, the flat, would have been sold, the loan would have been paid and she would have forfeited thousands of dollars (possibly tens of thousands of dollars) in Trustee's fees.

A Financial Rights solicitor attended the (then) Federal Magistrate's Court on the Monday and sought an extension of time on the basis that the client was seeking legal advice about a possible application to set aside the original judgment. An application was subsequently lodged in the Local Court and the judgment was eventually set aside. Several appearances were also required in the Federal Magistrate's Court to seek further adjournments of the Creditor's Petition while this process was taking place.

Filing a Debtor's Petition

In some cases, your client may decide that bankruptcy is their best option, or is inevitable, and wish to file a Debtor's Petition rather than wait for a Creditor's Petition to be heard.

Advantages of filing a Debtor's Petition

- The Official Trustee will be initially appointed as the trustee in bankruptcy. There is no guarantee that the Official Trustee will remain as the Trustee – AFSA may allocate the estate to a Registered Trustee, or the creditors may seek to appoint a Registered Trustee of their choice.
- The client can nominate their own Registered Trustee if they have a preference. However, if the Petitioning Creditor has obtained the consent of another Registered Trustee to administer the estate, generally the estate is then transferred to that Trustee. The creditors have the ultimate say as to the appointment of the Trustee.
- The usual 3 years until discharge will commence (if the client waits for the sequestration order to be made and then files a statement of affairs as required, it could be weeks or even months before the bankruptcy commences).

Disadvantages

- The client will need to act quickly to get the paperwork done.
- AFSA may reject the Debtor's Petition if it is too late to lodge (see below).
- It may be to the client's advantage to delay the date of the bankruptcy as long as possible because of previous transactions which may otherwise fall within the relation back period or be caught as undervalue transactions.

When is it too late to lodge a Debtor's Petition?

A Debtor's Petition will usually be accepted as long as it is lodged at least a full working day before the Creditor's Petition hearing. To be safe, your client should aim to lodge the Debtor's Petition at least two working days prior to the listed hearing date.

A Debtor's Petition must be referred to the Court in the following circumstances:

- where the debtor is one of a group of debtors against which a Creditor's Petition is pending (whether they are joint debtors or members of a partnership) (s 55(3B))
- where one or more members of a partnership have lodged a Debtor's Petition but not all the members of a partnership (s 56C(1)(a))
- where all the members of a partnership have lodged a Debtor's Petition and there is a Creditor's Petition pending against one or more but not all the members of a partnership (if the Creditor's Petition is against all of them there is no need to refer the matter to the court) (s 56C(1)(b)).
- where two or more debtors have lodged a joint Debtor's Petition and at least one (but not all) of them is subject to a pending Creditor's Petition (s 57(3B)).

Usually, AFSA will contact the debtors to discuss whether they wish to withdraw the petition before referring it to the court.

Petitioning creditor's costs

When the court is made aware that the debtor has become bankrupt on a Debtor's Petition, the court will generally dismiss the Creditor's Petition and order that the petitioning creditor's costs be paid out of the estate as if a sequestration order had been made. Accordingly, the bankrupt does not incur a fresh personal liability for such costs. It is advisable to notify the solicitors acting for the petitioning creditor when the debtor has presented their Debtor's Petition.

Opposing the Creditor's Petition

A debtor wanting to oppose a Creditor's Petition must file a notice of appearance and a notice of opposition, with supporting evidence, at least 3 days before the hearing and serve it on the creditor (Federal Circuit and Family Court of Australia (Division 2) (Bankruptcy) Rules 2021, Rule 2.06).

The client can oppose the Creditor's Petition on a number of grounds including, but not limited to, the following:

- the debt is no longer owed
- the debt was never owed
- the debt is below the threshold
- solvency (the client can pay their debts as they fall due)
- no act of bankruptcy or act of bankruptcy more than 6 months ago

The debt is no longer owed

If the debt has been paid in full by your client, and that payment has been accepted by the creditor, then the sequestration order cannot be made (s 52(2)). This is why it is very important for people to pay if they possibly can, even if they find the prospect completely objectionable. Getting out of bankruptcy once a sequestration order has been made is much more difficult and expensive!

It is essential that the technical difference between tendering a payment towards the debt and the acceptance of a payment towards the debt by the creditor is understood. For example, if the client has direct deposit account details, simply depositing the money won't be enough – the creditor still has the option of returning the money within a reasonable time and indicating that they will not accept payment.

The importance of this difference is that, after an act of bankruptcy, tendering a payment towards the debt will not have a binding effect on the creditor, and will not reduce the

amount of the debt. If the payment is accepted, however, the debt will be reduced. In general, creditors will be hesitant to accept payments from a debtor after an act of bankruptcy, on the basis that if there are other creditors pursuing a debt from your client, those payments might need to be paid back (as preferential payments) to the eventual Trustee to help satisfy the debts of other creditors. The distinction between the tendering and accepting a payment won't always be black and white – acceptance by a creditor might be able to be demonstrated by conduct alone. For example, if your client deposits the amount in the creditors account and several weeks have passed without it being returned, or better a receipt or statement is received noting the payment made and not indicating any intention to reject it.

In practice there will often be a negotiation between the debtor and the creditor with the aim of having the Creditor's Petition dismissed (or adjourned) by consent. As part of this negotiation, the creditor will usually ask the debtor to pay the creditor's legal costs to date as a condition of both accepting the payment and agreeing to the dismissal of the Creditor's Petition.

If the creditor is hesitant to accept payment it could be useful to indicate that there are no other significant creditors (if this is true) or to offer payment tendered by a family member or friend. This would minimise the chances that the money could be taken back from the creditor by the trustee as a preferential payment. To avoid the risk of a payment being recovered by the Trustee as a preferential payment, there must be no contractual relationship between the debtor and the third party paying the money which requires the third party to pay the money (or the potential bankrupt to repay the third party), and the payment offered must be from funds/property that is in the sole ownership of the third party.

The debt was never owed

As a Creditor's Petition is most often based upon the failure to pay in accordance with a Bankruptcy Notice, which itself is based on a judgment debt, it is difficult to argue that there is no debt at this late stage. Nevertheless, the court does have a limited to power to look behind the original judgment debt in some circumstances. This is more likely to be the case where there is a default judgment. The bankruptcy courts have the power to look behind a judgment obtained after a hearing, but this power will usually only be exercised in exceptional circumstances – generally to look behind a judgment, default or otherwise, there would need to be "circumstances tending to show that there has been fraud, or collusion, or miscarriage of justice". The debtor should get urgent legal advice before pursuing this option. In most cases this situation would be more appropriately dealt with by applying to set aside the original judgment in the original court and seeking an adjournment of the bankruptcy proceedings.

The debt is less than the $10,000 threshold

If the court is not satisfied that the debt (or debts) on which the Creditor's Petition is based

are at least $10,000 in total, it has no power to make a sequestration order and should dismiss the petition.

If the amount owed exceeded the $10,000 threshold when the Creditor's Petition was filed but the debtor has since paid off enough money to reduce the amount below $10,000, then provided the creditor has accepted that payment, the Creditor's Petition should be dismissed. However, even if the judgment debt has reduced below threshold, the $10,000 can be made up of other amounts owing to the creditor, as long as they accrued prior to the act of bankruptcy relied on (usually the failure to pay in accordance with a Bankruptcy Notice). A typical example is a judgment by default for strata levies which is later combined with unpaid strata levies that were incurred post judgment but prior to the act of bankruptcy.

If a payment has been made but not been accepted, the debtor may be able to seek an adjournment, to try to raise the rest of the money and settle the matter with the creditor (see **Seeking an adjournment** above).

Even if the court agrees not to make the sequestration order, it is likely to order that the debtor pay the petitioning creditor's costs of the proceedings. As noted above, if your client is trying to settle the matter by consent, then they will usually need to pay the creditor's costs to date in addition to the original debt. The filing fees and legal costs are set out on the Court's website.

Proving that the debtor is solvent

If the court is satisfied that the debtor can pay their debts as they fall due, then it may dismiss the Creditor's Petition (s 52(2)).

Bankruptcy proceedings are inappropriate for debtors who are able to pay but simply reticent to do so. This is largely because it is recognised that bankruptcy affects all creditors rights and other enforcement mechanisms that are potentially available to a creditor where the debtor has capacity to pay. In practice, however, the solvency argument is **rarely made with success**, as it is not enough for the debtor to have assets which exceed their debts – they must be able to liquidate those assets (by sale or borrowing money against them) and pay their debts within a reasonable time in order to be found solvent. Again, from a practical point of view more cases are resolved through obtaining adjournments while the money is raised or a settlement reached, than through the debtor successfully arguing that they are solvent.

> **For example** – in the case of Quitlong (*Quitlong v ACM group* [2011] FMCA 688 (12 August 2011)), In finding that Mr Quitlong was **not solvent** the Federal

Magistrate noted that:

"It has not been established that Mr Quitlong's interest in his home is presently available or realisable……..Mr Quitlong is only a part owner of that property. There is no indication that his wife is willing for the property to be sold. On the contrary, he told the court that it was not the case that his wife was willing to sell the property; that she had made the major financial contribution to the property…."

It should be noted that Mr Quitlong was trying to set aside a *sequestration order* that had already been made. Had he raised his solvency prior to the making of the order, he may have had better success in at least getting an adjournment to try to raise the money. Generally, if there is a joint owner in such circumstances, the debtor should ask the joint owner to attend court or prepare an affidavit indicating their willingness to sell the property or their intention and capacity to buy out the debtor's share of the equity. Evidence of having placed the property for sale, or conditional approval for a loan, would also be useful.

For example – in the case of Maher [*Maher v Maher* [2022] FedCFamC2G 147]. Mr Maher was held to be **unable to pay his debts** even though his debts, at approximately $750 000, were less than his interest in the Maher partnership, which for him included interest in cattle in the amount of $711 000 and in land of at least $350 000. In finding that Mr Maher was not solvent, the Federal Magistrate noted that Mr Maher needed the consent of the other members of the partnership to liquidate his interest:

"The question of whether the respondent is able to pay his debts is not answered simply by reference to a balance sheet analysis. Instead, as this case perfectly illustrates, the inquiry must take account of the nature of the identified assets and the ability of the respondent to convert those assets into cash within a relatively short time…while there may be mechanisms available to the respondent to force a sale, including through the dissolution of the Maher partnership, there is presently no evidence before the Court as to how, and, critically, across what timeframes, such a process might occur."

It should be noted that Mr Maher was attempting to have a sequestration order set aside. Again, perhaps if the issue of solvency was raised earlier, the court would have ordered an adjournment to allow him to attempt to realise his assets.

Having sufficient income to pay a debt off over several years is also not sufficient to establish that the client is solvent, even where there is evidence that this is the creditor's only hope of recovery (because the client has little or no equity in any asset).

In general, the assessment of a debtor's solvency reflects one of the harshest aspects of bankruptcy law in Australia. More often than not a court will only consider a person solvent if they can pay their debts within a very short period of time. The reason for this is that the system has been developed to enable creditors to **quickly** recover their debts in circumstances where normal payment terms have not been complied with and there is a question mark over whether creditors will be able to be paid in full at all. For this reason, if your client is arguing that they are solvent based on their ability to sell an asset, such as their home, you should try to gather evidence to prove how quickly that property might be sold. For example, in the case of *James v Deputy Commissioner of Taxation* ([2010] FMCA 106) the debtor's request for 6 – 8 months, to enable him to sell his house was not considered by the court to be fast enough for the debtor to be said to be solvent.

No act of bankruptcy, or act of bankruptcy more than 6 months ago

If the failure to pay in accordance with a Bankruptcy Notice (or other alleged act of bankruptcy) occurred more than 6 months prior to the filing of the Creditor's Petition, your client may have grounds for opposing the petition.

If your client believes the Bankruptcy Notice was not valid but they did not take any action to oppose it at the relevant time (within the period for payment – usually 21 days), then they should get legal advice.

Stay of the sequestration order for up to 21 days

The Court has the power to make a sequestration order but stay its operation for up to 21 days (s 52(3)). This will not stop the debtor becoming bankrupt, but it will mean that the Trustee should not incur costs during the stay period. This will make it cheaper for the debtor to annul the bankruptcy if he or she is able to raise the money to pay the debts and legal costs within this time. It will also prevent any of the debtor's property from being sold or otherwise dealt with for the benefit of the creditors. This power has been used in cases where the debtor has argued unsuccessfully that he or she is solvent. The Judge or Registrar has taken the view that the debtor has not established that he or she is solvent but gives the stay to give the debtor one last chance to come up with the money.

What if my client wants to enter a Debt Agreement or Personal Insolvency Agreement (PIA)?

If your client is a good candidate for a Debt Agreement or a PIA (see **Chapter 5**) then they need to take urgent action to get assistance from a Debt Agreement Administrator or a Controlling Trustee.

If the client is considering a PIA, appointing a controlling trustee will place the Creditor's Petition process on hold (s 189AAA). The client will still need to attend court to inform the

court of the fact that a controlling trustee has been appointed and provide evidence of such an appointment. Clients should get legal advice before appointing a controlling trustee.

If the client is considering a Debt Agreement, then they will need to turn up to the Creditor's Petition hearing with:

- evidence of the Debt Agreement Proposal having been lodged or at least being prepared
- evidence as to why it would be in the creditors' interests to accept the Debt Agreement Proposal
- information about the date on which the proposal will be lodged, or if lodged, the date by which creditors will need to indicate their acceptance or otherwise.

You should ensure you explain the consequences of a Debt Agreement in considerable detail and particularly turn the client's mind to whether he or she would not be better off allowing the Creditor's Petition to proceed (for example, because eventual bankruptcy is likely in any event).

Power to take control of property or examine debtor prior to bankruptcy

It should be noted that the court has the power to order the Official Trustee, or a specific Registered Trustee, to take control of a debtor's property; order that the debtor be examined (including producing any books in their possession pertaining to the debtor or related entities); or make orders in relation to the debtor's property BEFORE making a sequestration order if:

- a Bankruptcy Notice has been issued and not complied with or a Creditor's Petition presented AND
- a creditor (or creditors) seeks the relevant orders AND
- the court is of the view that it is in the interests of the creditors to do so (s 50).

In the event that the Creditor's Petition is ultimately dismissed, the debtor may within 15 days apply for compensation for any loss that has resulted from the control order (Bankruptcy Regulations 2021 16). Creditors are only likely to use this process if there is a good reason to suspect that assets/funds and/or financial records will otherwise be destroyed or disposed of.