Chapter 3: Bankruptcy in a nutshell

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Bankruptcy in a nutshell

For those who are new to this area it is important to understand the concept of bankruptcy so that you can communicate this to your client. Bankruptcy is a complex topic with many, many rules and fairly frequent developments. However, at its core there are some fairly simple concepts.

Bankruptcy law provides important rights for debtors who are in so much debt they can't realistically meet their obligations. It can present an opportunity to wipe the slate clean and move on. When a debtor decides to go bankrupt, he or she presents a legal document called a Debtor's Petition. How to do this is covered in **Chapter 7**. The consequences of doing this are covered in very brief form in this Chapter and then in detail in **Chapter 6**.

It is also a mechanism for creditors to force an insolvent person to submit to the authority of a trustee who then acts to recover money, usually by the sale of the debtor's assets, for the creditors on a pro rata basis. While this is a necessary mechanism, it can have disproportionate and punitive consequences for debtors if used too readily as a substitute for ordinary debt collection. The process for forcing someone into bankruptcy by an order of the Court is called a Creditor's Petition. This aspect of bankruptcy, and what rights and options your client may have once this process is started, is explored in detail in this toolkit in **Chapter 10**.

When a person is bankrupt (either voluntarily or otherwise) they effectively lose control of some aspects of their finances for a set period of time (usually 3 years and 1 day but it can be longer), at the end of which they are released from most, but not all types of debts. At the end of the bankruptcy, the debtor is discharged. Any property of the debtor, apart from certain protected items and property, is taken and sold for the benefit of their creditors, and to recover the costs of administering the bankruptcy. Income above a designated amount is also taken for the creditors as income contributions. These contributions are assessed and payable for as long as the debtor remains an undischarged bankrupt or until their debts and the costs of administering the bankruptcy are paid (whichever occurs first). Contributions that are assessed during bankruptcy but not paid may prevent discharge or can be pursued even after discharge (even if this means that a bankrupt's trustee becomes their creditor, and potentially pursue a fresh set of proceedings that may result in the client's bankruptcy again!) Permission may be required to travel and there may be limitations on certain types of employment for the period of the bankruptcy. There are ongoing ramifications for the person's ability to obtain credit and sometimes insurance which outlive the bankruptcy itself. The details of what debts are forgiven at the end of the bankruptcy, what property is protected, what income contributions may have to be paid and other restrictions are included in **Chapter 6**.

At the point of entering bankruptcy certain property, and rights to recover money and property, automatically vest in the trustee in bankruptcy. The role of the trustee in bankruptcy may be performed by the Official Trustee or a private trustee known as a registered trustee and will be referred to throughout this kit as 'the Trustee'. Property acquired during bankruptcy will also vest in the Trustee. This property (whether owned at the beginning of the bankruptcy or acquired during bankruptcy) becomes known as the bankrupt estate. The bankrupt estate may continue after the bankrupt has been discharged from bankruptcy. This means that the bankrupt is then free to acquire more property but cannot claim any ownership in property pre-dating their discharge (such as in a family law settlement or legal action for a breach of contract that occurred before or during the bankruptcy (see **Chapter 6 Part 2** for exceptions where an action for breach of contract may be protected)) because this property will also vest in the Trustee and form part of the bankrupt estate. Some property may eventually re-vest in the bankrupt if it has not been claimed by the Trustee after many years, or be purchased back by the bankrupt after discharge, but this is relatively rare.

The law of bankruptcy in Australia is largely found in the *Bankruptcy Act 1966*. References to sections of legislation in this toolkit refer to the *Bankruptcy Act 1966* (as amended) unless otherwise specified. In some instances, it is also necessary to refer to the *Bankruptcy Regulations 1996*. Again, any reference to the regulations in this toolkit refers to the *Bankruptcy Regulations 1996*.

The Australian Financial Security Authority plays the role of Official Receiver and the Official Trustee and is referred to throughout this toolkit as 'AFSA'. AFSA also regulates private bankruptcy trustees (registered trustees who perform the role of trustee in bankruptcy) and Part IX Debt Agreement Administrators. AFSA is also responsible for the administration of the Personal Property Security Register (PPSR). AFSA publishes a range of information that is vitally important for financial counsellors on its website.

The consequences of bankruptcy in brief

The good

- The client will be discharged from the majority of debts and will get a fresh start.
- It will stop harassment by unsecured creditors.
- It will stop legal action by unsecured creditors to recover their money through the courts.
- It will stop seizure of goods by sheriff's officers.
- It will stop the garnisheeing of the client's wages and the garnisheeing of his or her bank accounts (with the exception of the ATO) but note that the client is required to make contributions if their income is above a certain threshold.
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It will protect some of the client's property, including:
  - ordinary clothing
  - most ordinary household furniture and effects
  - tools of trade (where value under the prescribed amount)
  - superannuation that has not been accessed prior to bankruptcy
  - life insurance and endowment policies
  - compensation payments for personal injury received by the bankrupt (TPD payments however may not always be protected – see **Chapters 6 & 8**)
  - possessions of a non-bankrupt person who the client lives with
  - motor vehicle that is not secured or leased and is valued under the relevant threshold
  - vehicle under finance where equity is under relevant prescribed amount threshold and the client can maintain payments
  - property held in trusts (get legal advice)
  - wedding rings depending on value
  - defence service loans
  - rural assistance grants (get advice).
- Income up to the relevant threshold is protected.
- Travel throughout Australia is unrestricted.
- Overseas travel is allowed if the client has received permission from the Trustee prior to travel.
- The client can operate as a sole trader, under certain conditions.

The bankruptcy usually ends after 3 years and 1 day

There is generally no criminal sanction (unless the borrower breaches an obligation or acts dishonestly).

There may be a great sense of relief and/or a reduction in stress.

The bankrupt may have more income available for living expenses once relieved of the requirement to pay some debts.

The Bad

- Fraudulent debts will not be discharged by bankruptcy.
- It will not clear HELP/HECS debts.
- It will not discharge child support debts.
- Unliquidated debts will not be discharged (see **Chapter 6 Part 1** for an explanation of unliquidated debts).
- It will not get rid of fines imposed by the court – Traffic and other infringements may be discharged but their non-payment may cause the suspension of the client's driver's licence or car registration.
- Valuables not protected in bankruptcy will be part of the estate administered by the Trustee (for example antiques, high value car, etc).

- If the client has an interest in any real estate this will be part of the estate administered by the Trustee.
- Gifts and winnings (during bankruptcy) will be part of the estate administered by the Trustee.
- If the client's income is over the bankruptcy threshold, he or she will have to contribute to the bankrupt estate from that income.
- The client may be required to surrender his or her passport and will need to seek permission to travel outside Australia (which attracts a fee and is not guaranteed to be approved).
- If clients breach their obligations during the bankruptcy, it may be extended (for 5 or 8 years) and there may be penalties.
- The client cannot be a director of a company. Past financial affairs may be investigated.
- Preferential payments to creditors or undervalued transactions may be subject to trustee investigation (see Chapter 6, for an explanation of preferential payments and undervalue transactions.
- Overseas real estate also vests in the bankrupt estate.
- A bankrupt cannot be a trustee of a trust.
- A bankrupt cannot have a self-managed super fund.

The ugly

- The bankruptcy will be listed on your client's credit report until 5 years from the commencement of bankruptcy, or until 2 years have passed from discharge – whichever is **later**. Impacting the ability to get credit. For example:
    - if the bankruptcy is accepted on 1 January 2025, the bankrupt will be discharged on 2 January 2028 and it will come off their credit report on 1 January 2030
    - if the bankruptcy is extended, and the bankrupt is not discharged until 9 February 2029, it will remain on their credit file until 9 February 2031.
- The client's name will be on the National Personal Insolvency Index (NPII) forever.
- The client may have trouble getting credit in the future (even after the credit report listing has expired).
- The client may have difficulty getting insurance, or have special conditions imposed.
- It may affect the client's ability to rent property in which to live.
- Property that has vested in the Trustee during the bankruptcy will continue to be vested with the trustee after discharge (if not already sold).
- It can affect employment opportunities for the client..
- It can affect the client's ability to work in certain professions for life.
- It may affect the client's ability to connect to utilities and other services.

Inheritances (where the person dies during or prior to bankruptcy) will be part of the estate administered by the Trustee.

These issues are all covered in more detail in **Chapter 6**.