Decisions leading to bankruptcy

and tips for the unwary

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THE TITLE "DECISIONS" LEADING TO BANKRUPTCY IS PERHAPS A MISNOMER FOR MANY PEOPLE WHO END UP BANKRUPT. DECISION-MAKING IMPLIES CERTAIN ATTENTIVENESS, WHEREAS MANY PEOPLE WHO FIND THEMSELVES FACING BANKRUPTCY ARE FREQUENTLY IN THAT POSITION BECAUSE OF CAREFREENESS. THIS IS NOT TO CRITICIZE THOSE FACING BANKRUPTCY, WHO ALSO MOSTLY HAVE SUFFERED FROM IMPROVIDENT MACRO-ECONOMIC CIRCUMSTANCES, BUT IT IS A COMMENT ON THE TYPE OF CLIENT THAT WE AS LAWYERS MUST MANAGE.

Our clients are the ones who took an expensive holiday when they should have paid their other bills, or lost an unnecessary court case, or – all too commonly – failed to open the letters serving them with legal documents. Perhaps then the biggest procedural tip for the unwary litigator on either side of proceedings is not in law, but rather in practice: as pleasant as your client may be, they may also be somewhat carefree and difficult to manage.

In the Northern Territory, you may find yourself contemplating advice to make someone bankrupt more frequently now than in previous years. This is contrary to the national trend.

The rates of personal insolvency activity, including bankruptcy, Part IX debt agreements, and Part X personal insolvency agreements, have steadily fallen over the past year. Across Australia, personal insolvency activity fell 9.04 per cent from the June quarter 2013 to the June quarter 2014. This has been a trend since the wake of the Global Financial Crisis and is demonstrated in Diagram 1:

However, we have not been so lucky in the Northern Territory. Perhaps revealing the tapering off of the minerals and petroleum boom, combined with reduced funding from the Intervention in regional areas, personal insolvency activity in the Northern Territory has risen 4.35 per cent from the June quarter 2013 to the June quarter 2014. This is particularly pronounced in Alice Springs, but also readily visible

Quarterly personal insolvency activity in Australia

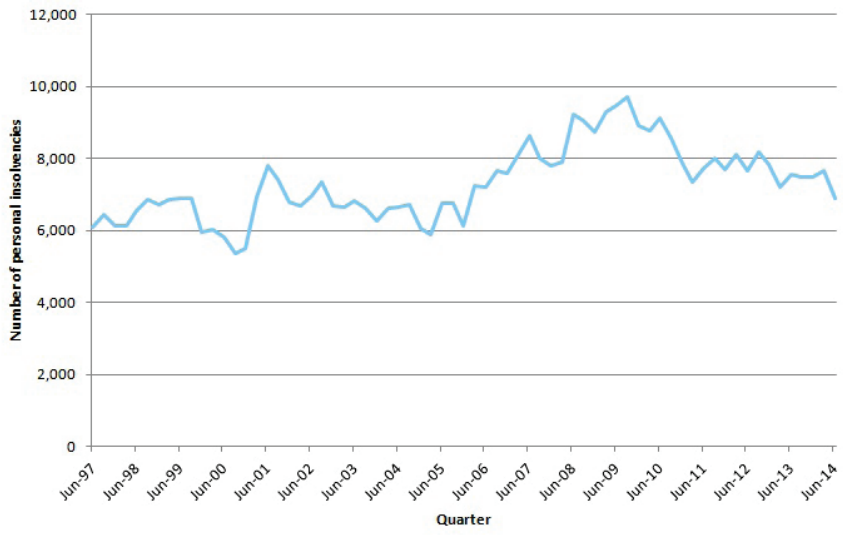

Diagram 1 - *Source: Australian Financial Security Authority, Australian Government, Commentary: June quarter 2014 <https://www.afsa.gov.au/resources/statistics/provisional-bankruptcy-and-personal-insolvency-statistics/quarterly-statistics/commentary-june-quarter-2014>*

June Quarter 2014

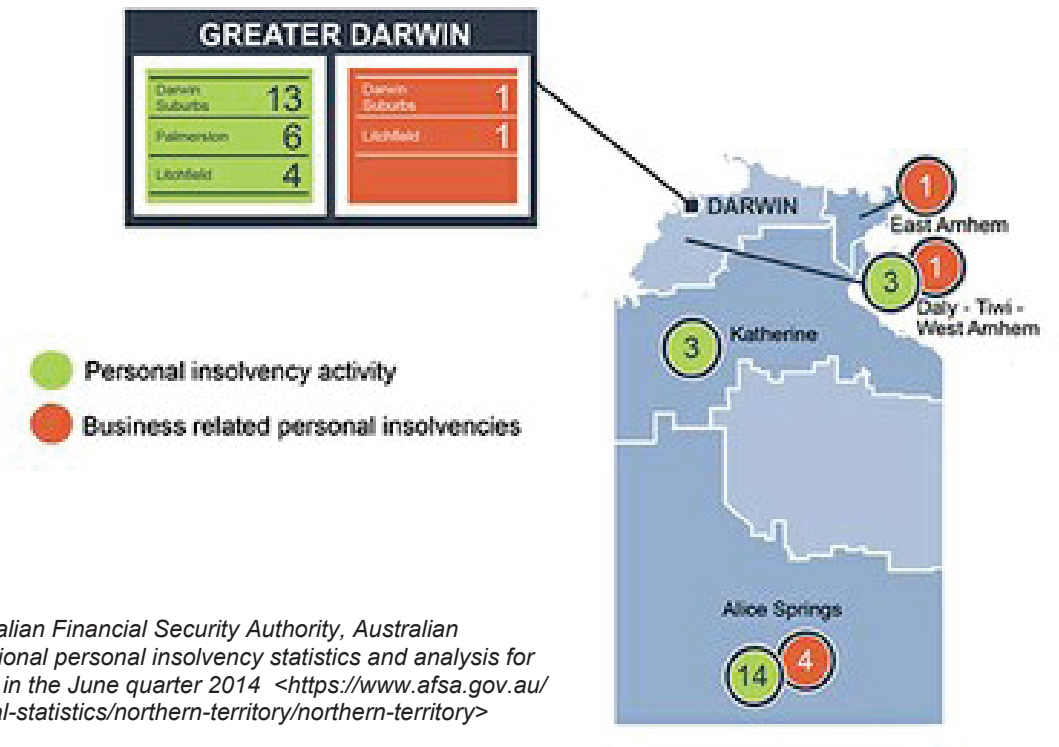

Diagram 2 - *Source: Australian Financial Security Authority, Australian Government, Quarterly regional personal insolvency statistics and analysis for the Northern Territory (NT) in the June quarter 2014 <https://www.afsa.gov.au/resources/statistics/regional-statistics/northern-territory/northern-territory>*

in Greater Darwin as Diagram 2 demonstrates.

Depending on the economic forecasts you choose to believe, it may be that the Northern Territory will continue to defy the national trend for some time yet.

Bankruptcy law can be divided into two major categories stemming firstly from personal insolvency, and secondly from corporate insolvency. The regime for personal insolvency is found in the *Bankruptcy Act* 1966 (Cth) ("the Act"), whereas the Corporations Act 2001 (Cth) governs corporate insolvency. This paper deals only with personal bankruptcy and insolvency as dealt with under the *Bankruptcy Act* 1966 (Cth). This paper addresses the following issues:

- When to decide to make somebody bankrupt and why?
- Considering the options available: matters to investigate before commencing proceedings;
- Relation back period and disposal of property;
- Transfers to defeat creditors: s121 Bankruptcy Act;
- Negotiation: 3rd party payments; and
- Part IX Arrangements.

When to decide to make somebody bankrupt and why?

There is no simple answer to this question, although in the first instance a potential bankrupt should be insolvent. Insolvency cannot be presumed of someone who has not paid his or her debts and the adjectives "insolvency" and "bankruptcy" are not synonymous.[1]

Accountants define insolvency in two major ways:

1. **'Cashflow' or 'Commercial Insolvency':** where a person is unable to pay their debts when they fall due; and
2. **'Balance Sheet Insolvency':** where total liabilities are greater than total assets.

Insolvency under the Act is defined in negative terms. s5(3) of the Act says "A person who is not solvent is insolvent", whilst s5(2) of the Act says:

> "A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable."

Hence, in the common circumstance of a person being unable to pay a judgment debt when it falls due a person must consider a debtor's:

- Total assets, if known;
- Ability to pay in an acceptable timeframe; and
- Willingness to pay.

Meeting the criteria of insolvent under the Act should certainly not inevitably lead to a creditor seeking to make the debtor bankrupt. If, a creditor is satisfied that a person meets the definition of insolvency under the Act, but is still balance sheet solvent, then bankruptcy need not inevitably flow from insolvency.

Scenario:

Joe is a truck driver. He is married and has two children. Joe and his wife rent their Winnellie home for $500 per week. Their only assets are two cars valued at $1000 and $5000. They have only $1000 in a joint bank account.

- In 2010 Joe decided to buy his own truck and deliver goods between Darwin and Brisbane. The truck cost $300,000. Initially he was able to pay the instalments on his truck and the other overheads.
- By late 2013, after the demand for freight in Darwin reduced, he could barely pay his bills.
- In May 2014, Joe's diesel mechanic successfully sued him for an outstanding bill of $30,000.
- In June 2014, Joe took his family on a $10,000 holiday to Bali.
- At present the truck is valued at $150,000 but Joe owes $200,000 on the secured loan.

What would appear to be the best option for the diesel mechanic given these limited facts?

Advice:

Joe does not appear to be operating his business as an incorporated entity. Therefore the diesel mechanic would need to look at the options under the Act. Bankruptcy would result in Joe having his financial affairs under the control of a trustee in bankruptcy. This may last for as long as three years. Joe would undoubtedly 'lose' his truck in the process, and his capacity to repay his debts also may be lost. Joe does not own his home so there appears to be little of his personal assets to seized. Joe could petition for his own bankruptcy. The advantage from Joe's point of view would be that at the end of this period he would no longer be liable for those debts.

An alternative would be to look for a Part IX or Part X arrangement. This would have the advantage of not being a formal bankruptcy, and may allow Joe to continue his operations. However, the business appears to be unprofitable so it is uncertain if this would be of long-term advantage to him. Also, it seems unlikely that there is a source of outside funds that Joe could draw on, so it is not clear what may be in it for creditors.

In Joe's fraught circumstance, which in fact reflects the reality of many in improvident macro-economic circumstances, perhaps the person keenest to enter bankruptcy would Joe himself. Conversely, and somewhat ironically, the person keenest to see Joe not enter bankruptcy would likely be the diesel mechanic.

Considering the options available: matters to investigate before commencing proceedings

Broadly, the considerations to investigate before commencing proceedings include:[2]

1. What unprotected property will vest in the trustee;
2. The liabilities, both actual and prospective;
3. The future assets, in particular any deceased estate that may vest in the trustee as after-acquired property;
4. Any superannuation and trust assets that may be protected;
5. Any income that is expected to be earned by the bankrupt in the three years of bankruptcy from which contributions can be taken;
6. The effects bankruptcy would have on the debtor's earning potential, particularly if they are a professional;
7. What transfers the debtor has made before bankruptcy that may be recovered by the trustee; and
8. Ownership of the family home.

Unless a person is not just insolvent, but hopelessly insolvent both under the Act and on the balance sheets, then there are usually other options to bankruptcy that can be tailored to fit the situation. By way of an example refer to the senario above.[3]

Relation back period and disposal of property

'Property' is defined in broad terms under s5 of the Act. Unless this property is subject to an exception, it vests in the trustee on bankruptcy under s58 of the Act, where under s16(1) all property that belonged to on or after the commencement of the bankruptcy becomes divisible amongst creditors.

Exceptions are found under s 116(2) and include such things as: household property,[4] sentimental personal possessions, and some tools of trade and personal vehicles valued under the relevant prescribed limit.[5]

The date of the commencement of the bankruptcy is crucial to the doctrine of relation back. The date of the commencement of the bankruptcy is the date the debtor committed an act of bankruptcy under s40 of the Act. In litigation, the date of bankruptcy is usually non-compliance with a bankruptcy notice under s41(1)(g).

The doctrine of relation back "is that all subsequent dealings with the debtor's property must be treated as if the bankruptcy had taken place at the moment when the act of bankruptcy was committed".[6] Of note however, under s115 of the Act, a creditor's petition must be presented within six months of the act of bankruptcy occurring for the relation back period to have effect.

Transfers to defeat creditors: s121 Bankruptcy Act

It should come as no surprise that many debtors seek to defeat their creditors' claims on their assets when impending bankruptcy looms. There are many motivations for this, which seem to revolve around the twin goal posts of protecting family assets and spite. However, these goal posts are frequently a trap and lawyers and accountants would be well advised to guide their clients' efforts carefully.

In addition to the doctrine of relation back, there are several sections of the Act that serve to void transactions prior to the act of bankruptcy occurring. These seek to prevent a debtor from defeating the effect of the sequestration orders by divesting themselves of assets. These are undervalued transaction under s 120, transfers to defeat creditors under s 121, and voidable preferences under s122. The most common of these seems to be transfers to defeat creditors.

Property transfers that occurred prior to the commencement of the bankruptcy are voidable under s121 of the Act when the:

1. Property would probably have formed part of the bankrupt's estate and been available to creditors if it had not been transferred; and
2. Bankrupt's 'main purpose' in making the property transfer was to prevent the property becoming divisible, or to hinder or delay the division of property among the bankrupt's creditors.

The burden of proving the bankrupt's 'main purpose' falls to the trustee, which seems onerous, but the trustee is assisted in this by s121(2) of the Act. Here, a bankrupt's main purpose is taken to be to defeat creditors "if it can be reasonably inferred from all the circumstances that, at the time of transfer, the transferor was, or was about to become, insolvent". In turn, a bankrupt must prove that they indeed acted in good faith under s121(4) for the property transfer to be valid. This means that the transfer:

1. Must have been at fair market value, and
2. The transferee did not and could not know that the bankrupt's main purpose was to defeat their creditors; and
3. The transferee did not and could not infer that the bankrupt was insolvent at the time of transfer.

The impact of s121 can be illustrated with a development of the previous scenario:

Developed scenario:

In addition to the previous facts:

- In July 2014, Joe sold his boat worth $40,000 to his father for $5,000. Joe's father contributed $10,000 to the purchase of the boat in January 2012, but was not a registered owner.
- In August 2014, Joe failed to comply with a bankruptcy notice.

What would now appear to be the best option for the diesel mechanic given these limited facts?

Advice:

Given that the boat was not sold for fair market value, and Joe's father probably could have reasonably inferred that Joe was insolvent at the time of transfer, this transaction is likely voidable.

Negotiation: 3rd party payments

Where possible, third party payments to discharge a debt are

Provisional personal insolvency activity June quarter 2014

State/ territory	Bankruptcies (Parts IV & XI)	Debt agreements (Part IX)	Personal insolvency agreements (Part X)	Total personal insolvency activity
NSW	1,245	958	14	2,217
ACT	52	55	0	107
Vic	778	577	11	1,366
QLD	1,159	861	11	2,031
SA	246	127	2	375
NT	22	26	0	48
WA	255	290	10	555
Tas	100	85	0	185
Total	**3,857**	**2,979**	**48**	**6,884**

Table 1 - *Source: Australian Financial Security Authority, Australian Government, Quarterly statistics: June quarter 2014 <https://www.afsa.gov.au/resources/statistics/provisional-bankruptcy-and-personal-insolvency-statistics/quarterly-statistics/quarterly-statistics-june-quarter-2014>*

a useful alternative to bankruptcy. In practice, securing third party payments requires patience and superior negotiation skills. It is common for hard-edged litigators to so poison proceedings that third parties choose not to become involved, even where it might be in their best interests. This is particularly so where debtors are self-represented and potential third parties are family members.

The changed fact scenario of Joe above raises the issue of third party payments from his father. Whereas in the initial fact scenario it seemed unlikely that there was a source of outside funds Joe could draw upon, now it seems that Joe's father has an interest in Joe's boat. This provides scope for negotiation with Joe's father, who in practice may be well advised to discharge part of the debt in order that the property transfer is not voided. This would be an ideal outcome for the diesel mechanic, but one that still may be difficult to negotiate.

Part IX Arrangements

Part IX and Part X agreements are the major alternatives to bankruptcy. Part IX debt agreements are more common and more flexible than Part X personal insolvency agreements. However, they only cater for those who are insolvent but with low levels of debt, few assets, and a low income. Part IX arrangements are most common with consumer bankruptcies. Part X agreements are more formal and more costly, but still avoid the inflexibility of bankruptcy. The rate of Part IX and Part X arrangements can be seen in Table 1:

As Part IX arrangements are substantially more common than Part X arrangements, indeed there being no Part X arrangements in the Northern Territory in the June quarter, only Part IX arrangements will be addressed.

A person who is an insolvent debtor under s185 of the Act may propose Part IX arrangements through the Official Receiver at the Australian Financial Security Authorities (formerly called the Insolvency & Trustee Service Australia) under s 185C. Such a proposal constitutes an act of bankruptcy under s40(1)(ha). Under s185C(2)(d)-(j), the proposal must contain the following mandatory terms:

- All provable debts must rank equally;
- A creditor cannot receive more than 100c in the dollar;

- The quantum of provable debt is ascertained at the time the original proposal is accepted for processing; and
- The entitlement of secured creditors to distributions is limited to the unsecured portion of their claim.

If the proposal meets the mandatory terms under s185C(2)(d)-(j) of the Act, the Official Receiver may accept the statement of affairs and accompanying proposal complies with the form in s165E(2) and under s185C(4) the debtor:

- Has not been bankrupt or had a Part IX or Part X arrangement in the past 10 years;
- Has unsecured debts and divisible assets under the threshold (currently $105,086.80); and
- Earns under the threshold amount after tax (currently $78,815.10).

Once the Officer Receiver accepts the original proposal for processing, he or she writes to each affected creditor under s185EA of the Act putting the proposal to them. There is then a moratorium on proceedings under s185K(1) from the date of acceptance of the proposal for the life of the debt agreement. This moratorium continues until either:

- All debts have been discharged under s185NA;
- The agreement is terminated under s185P;
- The agreement is declared void by the Court under s185Q;
- The debtor has fallen in arrears of six months under s185QA; or
- The debtor has become bankrupt under s185R.

Conclusion

There are several possible conclusions to this paper, but two will suffice. Firstly, and borrowing from Leon Trotsky: "you might not be interested in insolvency, but insolvency is interested in you!" Rest assured that in the Northern Territory's present uncertain economic climate that insolvency will arise whether or not it is welcome. Secondly, be wary of costs. In the scenario of Joe the truck driver you may conclude that a Part IX agreement with third party contributions is the ideal outcome for the diesel mechanic. This is true only if the cost of the legal, accounting, and filing fees is less than the sum recouped. This is not guaranteed on a $30,000 judgment debt unless the matter is handled prudently. ●

(Endnotes)

1. I.F. Fletcher, *The Law of Insolvency* (4th ed, 2009), 1-7.
2. Michael Murray & Jason Harris, *Keay's Insolvency: Personal and Corporate Law and Practice* (7th ed, 2011), [2.105].
3. This example is adapted from an example I used in teaching LAW 3110 *Insolvency & Restructuring Law* at the University of Southern Queensland in semester two 2012.
4. See Reg 6.03 *Bankruptcy Regulations 1996* (Cth) for details.
5. See Reg 6.03B *Bankruptcy Regulations 1996* (Cth) for details.
6. In *Re Pollitt; Ex parte Minor* (1893) 1 QB 455, 457-458 cited in *Re Edelsten* [1988] FCA 395 quoted in Michael Murray & Jason Harris, *Keay's Insolvency: Personal and Corporate Law and Practice* (7th ed, 2011), [2.95].