2nd edition

The Bankruptcy Handbook

Betty Weule
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2007

Published in Sydney by:
The Federation Press
PO Box 45, Annandale, NSW, 2038
71 John St, Leichhardt, NSW, 2040
Ph (02) 9552 2200 Fax (02) 9552 1681
E-mail: info@federationpress.com.au
Website: http://www.federationpress.com.au

National Library of Australia
Cataloguing-in-Publication entry

The Bankruptcy Handbook
2nd ed.
Authors: Weule, Betty; Warburton, Wayne; Brading, Richard.

Includes index.
ISBN 978 186287 621 7

Bankruptcy – Australia – Handbooks, manuals, etc

332.750994

Typeset by The Federation Press, Sydney, NSW.
Printed by Griffin Press, South Australia.

Preface

There is currently a significant place for a revision of *The Bankruptcy Handbook*. Since it was first published in 1998, there have been a number of important changes to the *Bankruptcy Act* 1966 and the way that the Insolvency and Trustee Service Australia (ITSA) interprets the Act. In particular, the repeal of early discharge provisions, the proliferation of private debt administrators, and the ongoing change in the relationship between bankruptcy and family law.

This book is addressed to financial counsellors but is of value to all who are involved in the insolvency field. It provides a broad overview and practical advice. It will be of interest to consumers, insolvency practitioners, debt agreement administrators, credit managers, mercantile and debt collection agents, accounts managers, and everyone else with an interest in consumer rights and bankruptcy.

Financial counsellors in rural and remote regions of Australia as well as the big cities will use the *Handbook* because bankruptcy can happen to anyone, anywhere.

Acknowledgements

Special thanks to Bob Cruickshanks, Deputy Official Receiver for New South Wales and the Australian Capital Territory and George Caddy, former Official Receiver, for their invaluable contributions, encouragement and assistance. Both Bob and George have over the years provided help and friendship to the financial counsellors of New South Wales.

Thanks to Wayne Warburton for identifying the need for this revised edition of *The Bankruptcy Handbook* and the work he put in to make it happen. Thanks also to Jennifer Gracie from the National Financial Counsellors' Resource Service for her support, advice and practical assistance.

We are grateful to the Department of Families, Community Services and Indigenous Affairs (FaCSIA), who provided a significant financial contribution to make this book a reality.

It is important to note that the views and opinions expressed in this book are solely those of the authors, and do not represent the views of Wesley Counselling Services, the National Financial Counsellors' Resource Service, or its funding body, the Department of Families, Community Services and Indigenous Affairs.

About the authors

Betty Weule, MA PhD

Betty has been a financial counsellor for over 30 years. She was the founder of Credit Line Financial Counselling Services and established the first community based gambling service for clients in New South Wales in 1980. At one time Credit Line was the largest financial counselling service in Australia and its activities included a community legal service, Credit Helpline, a consumer education division and resourcing for federally funded financial counsellors. She was a Telstra Business Woman of the Year award recipient and received the NSW Government's Lifetime Achievement Award for Consumer Advocacy.

Betty has a PhD in law with a thesis on consumer bankruptcy, is the author of numerous books and articles and was a consultant in bankruptcy to the Federal Attorney-General for many years. She is currently the Training Co-ordinator for the Financial Counsellors Association of NSW and a member of the NSW Administrative Decisions tribunal.

Wayne Warburton, B Psych (Hons) PhD

Wayne has been a financial counsellor since 1996 and is also a registered psychologist. He currently works with the National Financial Counsellors' Resource Service, providing resources, support and supervision for financial counsellors funded under the Commonwealth Financial Counselling Program (CFCP). He is also a consumer advocate on such bodies as the Council of the Telecommunications Industry Ombudsman and the Telstra Credit Management Working Group.

Wayne has a PhD in psychology with a thesis on aggressive patterns of thought, and is a tertiary lecturer in areas such as human personality, human aggression and psychosis. He also provides training for counsellors on a range of topics, and is currently the principal editor for *Sharkwatch*, an award-winning journal for financial counsellors across Australia. Wayne has a number of publications in International and Australian journals and books.

Richard Brading, BEc LLB

Richard has been a solicitor since 1984 and the Principal Solicitor of Wesley Community Legal Service, Sydney, since 1994. He won the Minister's Award for Consumer Advocacy in 2006. Working for the only community legal centre in the world specialising in problem gambling, Richard has a strong interest in insolvency. Although gambling is only reported as the official cause of a small percentage of consumer bankruptcies, Richard believes it is a factor in many more. Richard is a regular contributor to *Sharkwatch* magazine <www.wesleymission.org.au/creditline/sharkwatch.asp>, to *New Directions* and a range of other publications.

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Introduction

When a person is unable to pay his or her debts as they fall due and is in a hopeless financial position, the law enables the debtor's property to be taken and sold. The proceeds of sale are distributed among the creditors who are owed money. The debtor is then released from his or her debts and allowed to make a fresh start. This is the purpose of bankruptcy law.

Historically, bankruptcy law reform has moved slowly. Over the years Australian lawmakers have been inclined to ignore the bankruptcy system in times of economic growth. However in recent years, with rising numbers of bankruptcies, an increase in debt agreement administrators, and public concerns over abuse of the bankruptcy system by some high profile lawyers and businesspeople, the pace of reform has quickened.

The *Bankruptcy Handbook* (2nd edition) has been written by financial counsellors and a credit advocate, primarily for the use of financial counsellors working with debtors who may be considering bankruptcy. It will also assist professionals in the bankruptcy field, including lawyers, trustees, mercantile agents, debt administrators and students. Those considering bankruptcy will also find useful information about the legal and financial processes involved, as well as the emotional issues that need to be considered.

The *Bankruptcy Handbook (2nd edition)* is written in plain language to keep it accessible to as many Australians as possible. It covers most of the commonly encountered situations related to bankruptcy, but legal advice may be required for specific or unusual issues.

In this book the *Bankruptcy Act* 1966 is referred to as the "Act". The *Bankruptcy Act* can be found under "Commonwealth Consolidated Acts" at <www.austlii.edu.au>. In addition, documents related to many of the issues discussed in this book can be retrieved from the website of the Insolvency and Trustee Service of Australia (ITSA) at <www.itsa.gov.au>.

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The history of bankruptcy

Failure to pay debts has always been considered a form of criminal behaviour as well as a breach of civil obligation. From primitive societies though to the present day, the treatment of insolvent debtors has tended to be punitive.

There are references to debtors, their wives and their children being sold into slavery for the non-payment of debts throughout the Old Testament. For example, Isaiah 50:1 pronounces "to which of my creditors did I sell you? Because of your sins you were sold". However, there was potential for release for the ancient Hebrew debtor. Deuteronomy 15:1-2 provides that every seven years outstanding debts were to be cancelled. On the one hand was judgment and punishment, on the other was forgiveness and rehabilitation.

In ancient Rome, a creditor had powerful rights over an insolvent debtor. A court hearing was held and if the debt was proven, the debtor was automatically granted 30 days in which to make payment. If the debt was not paid, the debtor was again brought before the court where the judge would assign the person of the debtor to the creditor. The creditor would have custody of the debtor and would take him to his house, place him in binds and feed him one pound of meal per day. The creditor was then obliged to bring the debtor back to court for the last three market days to give the debtor a chance to find a friend or relative who might redeem them. If no one came to pay the debt, the debtor was bound over to the absolute discretion of the creditor. In fact, if there was more than one creditor the law provided that the debtor could be cut into pieces and divided among the creditors on a pro-rata basis.

The term "bankruptcy" appears to have originated in Italy in the Middle Ages. It was the term given to a code of laws governing insolvent traders in the Italian and Spanish states at the time. This code was developed as a weapon against traders who fled from their creditors when they could not pay their debts. It comes from the Italian word *"banco rotto"* "broken bench" as the trader's trading table would be broken by creditors to prevent him or her running up additional debts.

The first English bankruptcy legislation was passed in 1542 during the reign of King Henry VIII and strengthened the rights of creditors against dishonest debtors. Once an act of bankruptcy was established, a group of Commissioners was given the power to seize and sell the property of the debtor who was imprisoned until the debts were paid.

The first attempt to moderate the harshness of the Tudor bankruptcy legislation was *The Statute of 4 Anne ch 17* in 1705. This law empowered the Lord Chancellor to grant a discharge from indebtedness to a debtor who had fulfilled all the requirements of the law. This included surrendering all his property and providing satisfactory answers to the interrogation of the Commissioners. The discharge not only freed the bankrupt from debts but also from imprisonment. Although the 1705 law provided some rehabilitative measure for the first time, it also introduced the death penalty for fraudulent debtors. Previously the most severe penalty was to have an ear cut off or be pilloried – a procedure some creditors would like to see re-introduced!

Lord Redesdale's *Insolvent Act* of 1813 established the first permanent insolvency court, the Court for the Relief of Insolvent Debtors. A debtor who had been imprisoned for three months was able to apply to the court for release. The debtor's property was taken and administered in the same way as in modern bankruptcy, that is, by proportionate distribution of the proceeds of sale among creditors.

Bankruptcy and insolvency law were distinct until the 20th century although they both had the same basic objectives, namely, to make assets of the debtor available to the creditors and to ensure that there was an equitable distribution of available assets to all creditors. Bankruptcy applied to traders and insolvency law applied to private individuals.

One of the reasons for the curious but enduring distinction between bankruptcy and insolvency was the prevailing social view that traders were reduced to a state of bankruptcy due to business problems while insolvents were poor money managers who, if they behaved responsibly, could have avoided their difficulties.

The social and economic climate of the 19th and 20th centuries made bankruptcy reform slow and difficult. There were many conflicting interests involved: justice for the creditors versus mercy for the debtor; moral outrage against bankruptcy versus economic reality; and idealism versus pragmatism. This was reflected in the classification of a bankrupt's certificate of discharge between 1849 and 1861. A first-class certificate was awarded to a bankrupt whose bankruptcy the court considered to have been wholly unavoidable – a no-fault bankruptcy. A second-class certificate was issued when the court considered the debt to be partially unavoidable, that is, the bankrupt was careless or reckless but not dishonest. A third-class certificate was issued when the trader's dishonesty caused the bankruptcy.

In 1926, the *Bankruptcy Amendment Act* (UK) provided modifications to some of the penal clauses. In the 1970s, public opinion about the operation of this Act started to build and the Cork Committee was appointed to investigate. It recommended changes to the legislation to simplify the outdated procedures. The Thatcher Government, while rejecting many of the more innovative recommendations of the Cork Committee, passed the *Insolvency Act* in 1986 to establish effective and straightforward procedures for dealing with personal insolvents for the benefit of their creditors. This legislation was directly relevant to bankruptcy legislation in Australia.

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Bankruptcy in Australia

The New South Wales Court of Civil Jurisdiction was established in 1788 by authority of the Warrant for Charter of Justice and the Charter for Establishing Courts of Civil and Criminal Jurisdiction for the Eastern Coast of New South Wales, 2 April 1787.

Being a convict settlement, the lawmakers in England could not see the necessity for the provision of bankruptcy and insolvency legislation in the new Australian colony, or even the establishment of a banking system. The Charter of Justice provided for enforcement of the payment of debts by seizure of goods or, failing that, imprisonment – the main sanction for failure to pay a debt. The only deterrent to creditors keeping debtors in prison was that the creditor was required to pay eight pence per week to maintain the debtor.

The early system of justice was under the control of the Judge Advocate, with appeal to the Governor. Debt recovery was the major issue dealt with by the court. Of the 6000 cases heard between 1788 and 1814, over 90 per cent were concerned with the non-payment of debts. In one sitting of the court in 1808, at a time when the population of the colony was under 6000, 1351 people were sentenced to prison for non-payment of debts.

The harsh conditions in the new colony, isolation from the rest of the European world, uncertain climate and haphazard business systems resulted in many prominent people experiencing severe financial trouble, including New South Wales' first four judges – Collins, Atkins, Dore and Bent – all of whom died insolvent. Even prominent colonists William Blaxland and Henry Parkes were insolvents, although they managed to avoid imprisonment because of their position and influence. An exception to this was Australia's first farmer, ex-convict James Ruse, who was returned to prison for his insolvency.

Although there was no provision for bankruptcy or insolvency, informal schemes of arrangement were proposed, accepted and eventually ratified by the court and stamped "settled by assignment". In some cases, the Governor, rather than the debtor, initiated insolvency-like hearings in an effort to force some kind of settlement that resulted in the release of the prisoner. Some debtors were released as a result of these initiatives, while others stayed in gaol when the creditors rejected the settlement proposal. These hearings were technically unlawful as they were outside the provisions in the Charter of Justice.

In 1806 Thomas Jones proposed one of the earliest recorded informal schemes. Imprisoned for debt, he placed an advertisement in the *Sydney Gazette* proposing a meeting of his creditors to consider his statement of affairs. Jones required the agreement of all creditors for his scheme to proceed and obtain his release from gaol. His proposal allowed for payment of all debts in full over a period of time. The meeting was held, all creditors agreed to the proposal, and Thomas Jones was released from prison. This scheme established a precedent for the informal schemes of arrangement that are used by financial counsellors today.

The chief difficulty with such informal schemes of arrangement was that they required the agreement of all creditors. Without bankruptcy legislation, debtors could be at the mercy of a single creditor who refused to accept their proposals. Six months after Jones successful proposal, William Bennett also placed an advertisement in the *Gazette*. However, he was not successful. One creditor refused to cooperate and he spent the next 15 months in gaol. Eventually he was released from gaol because his creditors were no longer prepared to pay for his upkeep.

Throughout Australia during the second quarter of the 19th century, imprisoned debtors and their friends campaigned for reform. In response to the campaign, debtors in Sydney and Melbourne were confined outside prison but in a special area of the town. This did not last, and following strong objections from creditors, the debtors in Sydney were moved to the new Darlinghurst gaol. They were not forced to live in cells, but in the Deputy Governor's house with their own exercise yard.

Bankruptcy Acts were introduced in the various States in the latter part of the 19th century. With Federation in 1900, the responsibility for bankruptcy and insolvency law passed to the Commonwealth. The first *Commonwealth Bankruptcy Act* was passed in 1924 and proclaimed in 1928, based primarily on the English Acts.

Change still moved slowly. In Australia, before the *Law Reform (Married Women and Tortfeasor's) Act* of 1935, a married woman could only be made bankrupt if she carried on a trade or business.

In 1956 the Clyne Committee was set up to review the *Bankruptcy Act* with the aim of improving its operation. The Committee reported that:

> It is accepted by the community that when a debtor has reached a position where he can no longer pay his debts in full, his property should be made available, through a Trustee, for distribution to his creditors, after which if his financial difficulties were a result of misfortune rather than dishonesty or extravagance, he be released from his liabilities and be given an opportunity to re-establish himself.

So many amendments were recommended by the Clyne Committee report that the government decided to draft a completely new law which became the *Bankruptcy Act* 1966 (Cth). The key changes included the adoption of automatic discharge five years after bankruptcy, and the creation of a statutory corporate "Official Receiver in Bankruptcy", comprising all of the Official Receivers together, to hold the property of the bankrupt estates they administered.

The 1980s saw an unprecedented growth in consumer debt. For the first time, Australia overtook America as the largest user of consumer credit on a per capita basis. Real wages did not keep pace with the cost of living, and many Australians used credit to maintain their standard of living. Credit became a product in its own right, actively and aggressively marketed.

There was a dramatic climb in the number of personal bankruptcies throughout the 1980s and into the 1990s. Personal bankruptcies in Australia rose from 3624 in the 1985/86 financial year to 10,196 in the 1991/92 financial year. Only a few of these bankrupts made significant contributions to their estates to pay a dividend to creditors.

At this time, the infamous businessman Christopher Skase was successfully evading his creditors. His lavish lifestyle outside Australia was much publicised, intensifying adverse public opinion. Skase was not the only businessperson whose empire had collapsed, but he became the most notorious.

It seemed as if everyone knew, or had heard of, someone who was bankrupt but who still drove around in a new BMW, had not lost their home, or was boasting of how they had ripped off the system. Skase became the catalyst for these feelings. There was considerable pressure on the Attorney-General to tighten up the laws "to catch Skase".

The rise in consumer bankruptcy numbers placed considerable strain on the resources available for bankruptcy administration. It became increasingly obvious to the government that bankruptcy law reform was not only necessary, but would require a system which was less complicated, more cost effective, fairer to bankrupts and which increased the rehabilitative aspects of the Act. These changes were made in the *Bankruptcy Amendment Act* 1991, and are often referred to as "the Skase amendments".

The 1991 reforms have, in general, been effective. There was an increase in the contributions paid to bankrupt estates from the higher income groups. Bankrupts also found it much more difficult to disguise their income to avoid contributions.

A system of early discharge for low-income consumers with no substantial assets was introduced in the 1991 reforms. Early discharge was abolished in May 2003 as a response to creditor complaints that it made bankruptcy "too easy".

However, when legislation is tightened to catch high-profile bankrupts, it is usually ordinary people who are the most affected. For example, legislation to prevent "high flyers" from leaving the country also made journeying overseas very difficult for bankrupts wanting to visit family in other countries on compassionate grounds.

Alan Bond fell from grace when he became bankrupt in 1992 with debts of over $500 million. Despite the fact that Bond's debts were enormous, he did not initially generate the same public antagonism as Skase. This was probably because he did not flee the country and had a reservoir of public goodwill related to his role in Australia's historic procurement of the America's Cup.

When his creditors accepted his "one-cent in the dollar" offer and he was successful in appealing against the inclusion of gifts and services in the assessment of his deemed income and contribution, the media and public opinion turned against him. His "loss of memory" when questioned about his missing assets also antagonised the general public. In response, the government introduced the *Bankruptcy Legislation Amendment Act* 1996, which has become known as the "Bond Amendments".

While these two pieces of legislation were the last of the major bankruptcy changes, there has been an ongoing process of change over the past decade.

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Bankruptcy today

The primary aims of bankruptcy are to:

- ❖ Provide a fair process for dealing with the financial affairs of insolvent debtors;
- ❖ Ensure an orderly distribution of the estate of the bankrupt among creditors; and
- ❖ Allow for the rehabilitation of the bankrupt.

Heading for bankruptcy

Insolvency is the inability of a person to pay his or her debts as they fall due. Bankruptcy is a change in the legal status of an insolvent person by either administrative process (that is, filing a Debtor's Petition) or by court order.

A debtor may become bankrupt in either of two ways:

- ❖ *By a Creditor's Petition.* A creditor can apply for a sequestration order to be made against the debtor by the Federal Court of Australia or the Federal Magistrates Court. The sequestration order is made if the court determines that the debtor has committed an act of bankruptcy and is insolvent. The Creditor's Petition process and court proceedings may be particularly stressful for the debtor.
- ❖ *Through a Debtor's Petition.* The debtor files their own petition at the Insolvency and Trustee Service of Australia (ITSA) – either by mail or in person. See the ITSA website <www.itsa.gov.au> for the current version of the Debtor's Petition. The Official Receiver has the discretion to reject a Debtor's Petition if it is considered that the debtor could pay his or her debts within a reasonable time and either:

  (a) does not appear willing to pay one or more of the debts, or

  (b) has been previously bankrupt three times, or

  (c) has been previously bankrupt in the past five years.

ITSA and the Official Receiver

The Insolvency and Trustee Service Australia is an agency of the Commonwealth Attorney-General's Department and is headed by the Inspector General in Bankruptcy. It is responsible for the oversight of bankruptcy administration and reports to the Attorney-General on the operation of the *Bankruptcy Act* 1966. ITSA is responsible for the administration of bankruptcies that are not administered by registered trustees.

The Official Receiver is the title of the principal officer of each ITSA office. Correspondence to ITSA should be addressed to the Official Receiver and should always refer to the bankrupt by name and number.

There have been some recent changes in the operation of ITSA. All Debt Agreement proposals are processed by either the Queensland or the Western Australian offices of ITSA, while Debtor's Petitions may be lodged by mail at any of the ITSA offices in the capital cities, Canberra and Townsville. All phone calls by debtors go to a call centre that has been established in South Australia. Financial counsellors are expected to soon have a dedicated number for advice. In some States, such as New South Wales, financial counsellors continue to use individual ITSA staff contacts.

Role of the financial counsellor

Always ensure that the client considers the alternatives to bankruptcy. If the client refuses to discuss options or think about the issues that accompany bankruptcy, then it may be best for the client to get the necessary papers directly from ITSA and complete them without your involvement. It is not the role of a financial counsellor to advise clients to proceed with bankruptcy. It is the role of the counsellor to help the client to explore all options. It must always be the client's decision whether or not to declare bankruptcy. It is NOT the role of the financial counsellor to simply assist filling out the paperwork.