

The purpose of this newsletter is to summarise the basic information we convey in conference to insolvent individuals (“debtors”) who, as a means of solving their debt problems, need to decide between becoming a bankrupt or entering into an arrangement with their creditors.

Bankruptcy

Introduction

Bankruptcy is a legally declared inability by an individual to repay debts. The applicable legislation is the Bankruptcy Act 1966 (“the Act”). It applies to individuals, partnerships, joint debtors and deceased estates. The bankruptcy is administered by a Trustee in Bankruptcy who is either the Official Receiver (a public servant) or a private Trustee.

Becoming a Bankrupt

There are two (2) ways a debtor can become bankrupt, namely:

- Debtors’ Petition – Where the debtor presents his or her own petition to the Official Receiver; or
- Creditors’ Petition – When a creditor presents a petition to the Court, a Sequestration Order may be made against the estate of a debtor.

For a petition to be presented, the debtor will need to have committed an act of bankruptcy, the most common being non-compliance with a Bankruptcy Notice, and be indebted to the creditor for an amount of at least \$5,000.

In the case of a Debtors’ Petition, the debtor can nominate a Trustee as compared to a Creditors’ Petition where the creditor can nominate a Trustee. The role of the Trustee is to investigate the financial affairs of the bankrupt; realise all available assets including transactions that may be voidable, and distribute to creditors realised funds in accordance with the Act without undue delay.

The Period of Bankruptcy

A bankrupt is automatically discharged three (3) years from the date the bankrupt files with the Official Receiver a Statement of Affairs. However, if the conduct of the bankrupt is unsatisfactory, then the period of bankruptcy can be extended by up to five (5) years upon an objection being lodged by the Trustee. Alternatively and at any time before discharge, the debtor can:

- seek an annulment pursuant to section 73 of the Act by submitting a proposal to creditors;
- seek an annulment pursuant to section 153A of the Act by paying out all creditors in full plus the costs of the bankruptcy; or
- in the case of a Creditors’ Petition, seek an annulment pursuant to section 153B of the Act by making an application to the Court.

Consequences of Bankruptcy

The main consequences of becoming a bankrupt include the following;

- A bankrupt will be recorded on the NPII (National Personal Insolvency Index) for life;
- A bankrupt’s credit rating will be affected for seven (7) years;
- Creditors are unable to commence or continue any further action for recovery of their debts against the bankrupt;
- A bankrupt’s property including after-acquired property will vest in the Trustee during bankruptcy and continue to vest with the Trustee after discharge if the property remains unsold. Certain property of the bankrupt is excluded from vesting in the Trustee;
- A bankrupt is required to make contributions from income to his or her estate if the income exceeds prescribed limits;
- A bankrupt cannot, without disclosing that he or she is an undischarged bankrupt, obtain credit (including the lease or hiring of goods) for an amount greater than an indexed amount;
- A bankrupt cannot carry on business alone or in partnership, under a name other than their own unless he or she discloses their real name and the fact that he or she is an undischarged bankrupt;
- A bankrupt is allowed to travel overseas but only with the written consent of the Trustee. However the bankrupt is required to deliver his or her passport(s) to the Trustee;

- A bankrupt is disqualified from acting as director and managing a corporation;
- On discharge from bankruptcy, the debtor is released from all debts provable in the bankruptcy including secured debts. There are a number of exceptions such as fines imposed by a Court and debts incurred by fraud.

Property the Bankrupt can Retain

The bankrupt is able to retain certain property including:

- Property held in trust for another person;
- Necessary clothing and household property and such other household property that creditors may resolve;
- Items of sentimental value, including awards of sporting, cultural, military or academic nature, as creditors may resolve;
- Property that is used by the bankrupt in earning income by personal exertion whose aggregate value does not exceed an indexed value and such other equipment as the creditors may resolve or the Court may order;
- Property used primarily as a method of transport up to an indexed value;
- Subject to certain conditions, life assurance and endowment assurance policies and proceeds from the policies in respect of the bankrupt and the bankrupt's spouse and the bankrupt's interest in superannuation policies and proceeds thereof;
- Any right of the bankrupt to recover compensation, damages and right of action for the death, personal injury or wrongs to oneself, their spouse or any family member;
- Property purchased from the proceeds received from endowment and annuity policies, compensation/damages claims or Rural Adjustment Schemes.

Income Contributions

If the debtor receives or is deemed to have received income above indexed amounts, then the debtor is liable to make contributions to his or her bankrupt estate. The definition of income is quite broad and includes income from personal exertion, certain benefits provided by third parties, income from trusts & superannuation funds, loans and so on. The amount of the contribution is calculated by using the following formula:

$$\frac{\text{Assessed Income} - \text{income tax} - \text{a statutory threshold amount} - \text{child support payments}}{2}$$

Arrangements with creditors

There are three types of arrangements that debtors can make with their creditors, namely:

- Formal Arrangement under Part X of the Act;
- Formal Arrangement under Part IX of the Act;
- Informal Arrangement.

Part X – Personal Insolvency Agreement

Introduction

Part X of the Act offers an alternative to bankruptcy by providing a debtor in financial difficulty with a formal but expensive mechanism to reach a binding arrangement with his or her creditors. The arrangements are individually tailored to suit the debtor's unique financial circumstances. The debtor is able to negotiate a settlement with creditors that most likely involves the payment of less than 100 cents in the dollar. A typical arrangement will usually provide for monies to be paid by the debtor or on account of the debtor either by way of lump sum or by instalments over a certain period of time. The arrangement can also provide for sale of specified assets with the remaining assets to be retained by the debtor.

The Process

The provisions of Part X are invoked by the debtor signing, what is called a Section 188 Authority, authorising either a Registered Trustee, a Solicitor or the Official Trustee (who is then referred to as the Controlling Trustee) to call a meeting of his or her creditors and to take control of his or her property. At the same time, the debtor must provide the Controlling Trustee with a proposal, including a draft personal insolvency agreement ("PIA"), and a Statement of Affairs outlining all known assets and liabilities of the debtor. A PIA takes the form of a deed and must include specified terms as set out in the Act.

The Controlling Trustee immediately takes control of the debtor's property and undertakes certain investigations into the affairs of the debtor. In addition, the Controlling Trustee is required to issue a report to creditors detailing the results of his or her investigations. This report is also required to contain a statement as to whether or not the PIA proposal is in the best interests of creditors.

The meeting to consider the debtor's proposal must be held not more than 25 working days after the appointment or 30 working days if the appointment was made in December. At the meeting, creditors may resolve by special resolution that the debtor be required to execute a PIA. Under the Act, a special resolution requires 50% in number AND 75% in value of creditors present at the meeting, voting in favour of the motion. If the proposal for the PIA is not accepted by creditors, then the most common outcome is for creditors to pass two special resolutions; one that the debtor presents a debtors' petition within 7 days and the other that the debtor's property be longer subject to control.

In the event that the proposal is accepted by creditors, then the deed must be executed by the debtor and the Controlling Trustee within 21 days from the day on which the special resolution is passed. Once all the terms of the deed are satisfied, the PIA is terminated. The Act also provides for the termination of the PIA if the debtor defaults on its terms. Alternatively the PIA may be varied. In addition and in specific circumstances, the court may also set aside a PIA and make such orders as it sees fit.

The Effect on the Debtor

Obviously, on signing a Section 188 Authority, the debtor will lose control of his property. Control of property that is excluded under the PIA will revert to the debtor on execution of the PIA. In addition and pursuant to subsection 206B(4) of the Corporations Act, a person is disqualified from acting as a director of a corporation if that person has entered into a PIA and the terms of the agreement have not been fully satisfied.

The Effect on Creditors

The effect of appointing a Controlling Trustee is that creditors are unable to commence or continue any further action for the recovery of their debts from the debtor until the outcome of a subsequent meeting of creditors is known. The rights of a secured creditor remain in tact.

Once the PIA has been signed, creditors, whether present at the meeting or not, are bound by the terms of the PIA and cannot take any action to recover their debts outside the PIA.

Commentary

Unfortunately, entering into a PIA will not be an appropriate alternative for all debtors, especially those with no resources (or access to limited resources) and relatively nominal debt exposure. The main reason for this is that the cost of proposing an arrangement under Part X of the Act can be prohibitive. In this regard, the Controlling Trustee is obligated to carry out the tasks detailed earlier herein and will incur significant time charge in doing so. As there is no guarantee that the proposal will be accepted by creditors, the prospective Controlling Trustee will normally seek a cash advance (or some other form of security) to meet his estimated costs in acting in that role. Furthermore, the debtor will need to fund the cost of preparing a formal deed setting out the provisions of the arrangement.

In considering whether or not to put a proposal to his or her creditors, a debtor should also take into account the likelihood of the proposal being accepted bearing in mind that under the Act, a special resolution is required being 50% in number and 75% in value of creditors voting on the motion. From experience, we have found that some creditors will vote against a proposal on the basis of policy, notwithstanding the commerciality of the proposal.

Nevertheless, entering into a PIA does have its advantages some of which are summarised hereunder:

- The debtor avoids the stigma of bankruptcy;
- A PIA provides for the flexible administration of the debtor's affairs including the opportunity to carry on business, which is difficult for an undischarged bankrupt;
- The execution of a PIA avoids Court process;
- The return to creditors under the PIA is invariably greater than that if the debtor was made bankrupt;
- Subject to the terms of the PIA, there is no requirement to contribute after- acquired property or income;
- The PIA will normally terminate within the short to medium term.

Part IX- Debt Agreement

Part IX of the Act provides another alternative to bankruptcy by providing debtors who have a relatively low income, minimal assets and low debt levels, with an inexpensive mechanism to reach a binding arrangement with their creditors to release them from their debts. This part of the Act is only available to be utilised by those debtors who have:

- not, within the previous ten (10) years, been bankrupt; a party to a debt agreement or given an authority under section 188 of the Act;
- unsecured debts that are below the specified threshold amount;
- property, which would be divisible among creditors in a bankruptcy, that is below the threshold amount;
- after tax income that is below the adjusted threshold amount in the year beginning at the proposal time.

The current threshold amounts are set out in the table below.

Unsecured Debts	\$92,037.40
Property	\$92,037.40
After Tax Income	\$69,028.05

The Process

To initiate a Debt Agreement, a debtor must give the Official Receiver a proposal for a binding agreement between the debtor and his or her creditors. Any such proposal must be in the approved form and identify the property to be dealt with under the agreement; specify how it is to be dealt with and authorise the Official Receiver, a registered Trustee, or another person, to deal with the property as specified.

The proposal must be accompanied by a statement of the debtor's affairs. If the proposal is accepted by the Official Receiver, the Official Receiver must write to creditors asking them whether the proposal should be accepted. The proposal is accepted if the majority in value of creditors who reply state that the proposal should be accepted.

The Debt Agreement ends when all the obligations that it created have been discharged. At that time the debtor is released from all debts which would be provable in a bankruptcy. This release from debts will not occur if the Debt Agreement is terminated by the debtor, creditors or the Court, or if the Debt Agreement is declared void by the Court. The Act also provides a mechanism to vary a Debt Agreement.

The Effect on Creditors

All creditors with provable debts are bound by the Debt Agreement, even those who voted against the proposal. While the Debt Agreement is in force, creditors cannot take or continue action against the debtor for recovery of their debts. A Debt Agreement does not affect the rights of a secured creditor to realise or otherwise deal with the creditor's security.

Commentary

We do not administer Debt Agreements. Readers requiring further information should access the web site maintained by the Insolvency and Trustee Service Australia at www.itsa.gov.au.

Informal arrangement

An informal arrangement is simply an arrangement not made under the Act that a debtor makes with his or her creditors to settle his or her debts. Normally an adviser such as the debtor's accountant, would firstly write to creditors summarising the debtor's financial position and putting forward a settlement proposal. Follow up contact by either the debtor or the advisor is recommended with the aim of addressing any concerns creditors may have and reinforcing the benefits of the proposal. Preferably any agreement reached with creditors should be documented by way of deed.

Informal arrangements are more likely to proceed in circumstances where there are a small number of creditors involved and some goodwill still exists between the parties. The difficulty is that just one hostile creditor can make the arrangement unworkable.

Contacts:

Chris Palmer

cpalmer@obp.com.au

Bryan Collis

bcollis@obp.com.au

Robert Ritchie

rritchie@obp.com.au

Andrew Cowled

acowled@obp.com.au



INSOLVENCY & BUSINESS RECOVERY

Level 14, 9 Hunter Street, Sydney NSW 2000 | GPO Box 3385, Sydney NSW 2001

Telephone: +61 (0)2 9232 3322 | **Facsimile:** +61 (0)2 9232 3388 | **Email:** obp1@obp.com.au | **Website:** www.obp.com.au

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