

Homes at risk: ***using bankruptcy*** ***to collect*** ***small debts***

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About Eastern Access Community Health (EACH)

EACH delivers a range of community health services that improve the physical, mental and social well-being of individuals, families and communities in Melbourne's eastern suburbs. Part of EACH's service provision is Financial Counselling.

The EACH Financial Counselling team assists low income, marginalised consumers who are experiencing financial difficulty. This free, independent, confidential service provides an overall assessment of consumers' financial situations, explores options for money and debt management, and supports consumers to pursue the option they choose.

Further information about EACH is available at www.each.com.au or the Financial Counselling team can be contacted on **03 9871 1800**.

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Currency

The law referred to in this report is current as at 31 March 2007.

EXECUTIVE SUMMARY

This project was initiated by two cases where family homes were threatened by collection of small debts. The initial concern was about the fees of trustees in bankruptcy. However, as the project progressed and further cases of financial counsellors were examined, it became equally concerning that creditors and their agents chose bankruptcy to collect these small debts.

Thirteen cases which involved risk to or loss of a home are outlined in the report. These cases rarely come to the attention of financial counsellors and community lawyers and therefore merit attention beyond their number. They are indicative of significant negative impact on some debtors and their families when bankruptcy is used to collect small debts.

Bankruptcy in Australia provides relief for debtors from debts they cannot pay. For the large majority of consumer bankrupts who have no assets, a low income, and a low level of debt, bankruptcy relieves stress and provides a fresh start. In almost all instances these debtors become bankrupt on their own voluntary petition. Their bankruptcies are administered by the Insolvency and Trustee Service Australia (ITSA) as the Official Trustee.

Where debtors become bankrupt as a result of a creditor's petition a Registered Trustee ("trustee") is appointed to administer their estate. This project considered the experience of financial counsellors and community lawyers where creditors' petitions and the resulting trustees' fees put the homes of consumer bankrupts at risk. While the number of consumer bankrupts who become bankrupt on a creditor's petition is small, the impact on them and their families is significant.

When a debtor becomes bankrupt on a creditor's petition and a trustee is appointed, control of the costs of administering their bankrupt estate diminishes. Assisted by lack of competition in the market, and their privileged position trustees accumulate fees with little independent oversight. In most of the reported cases trustees' fees were several times the amount of the original debt. Ultimately where there are significant assets such as equity in a family home, these costs are borne by the bankrupt.

The *Bankruptcy Act* 1966 obliges trustees to act in the interests of the debtor as well as the creditor. A trustee is charged to save the estate unnecessary expense by efficient, commercially sound administration. Maximizing returns from the estate to pay debts and provide a surplus to the bankrupt while minimizing trustee fees, protects the equity in a bankrupt's home to the extent possible.

In many cases debtors' action or inaction contributed to the risk to their homes. Often this was due to a dispute of the original debt; and/or a breakdown of negotiation with the creditor to pay the debt; and/or the debtor being unable to come to a repayment arrangement due to financial hardship. In some instances, the debtor ignored debt collection action hoping it would go away.

However, in the large majority of the cases in the report these debtors were vulnerable in a range of circumstances including that they had limited literacy skills; they were elderly; their first language was not English; they were suffering physical and/or mental illness; they were experiencing difficult life situations. In most cases they did not understand the bankruptcy process and its implications; and often when they tried to clarify it with their trustee and/or complained about their trustee's actions, the system let them down.

Fees are significantly escalated by the bankrupt's inquiries or challenges of the trustee's actions. This is the major cause of loss of equity and/or forced sale of the bankrupt's home. The limited remedies available to bankrupts to question trustees' fees do not operate effectively as bankrupts do not have the capacity to pursue them.

The risk to and loss of family homes of consumer bankrupts is seriously disproportionate to the debts owed. The operation of the Bankruptcy Act for consumer debtors where equity in their homes exceeds their liabilities has been questioned. Are they insolvent? Is bankruptcy appropriate to collect these debts?

Better solutions should be found to protect the homes of debtors and their families. Engagement by all stakeholders is essential to address problems identified in the report.

Key findings

The original debts on which creditors issued petitions were small. A debt of less than \$10,000 led to bankruptcy or threat of bankruptcy in 76% of the cases in the report.

Creditor's petitions are much more likely to be used by debt collectors acting for mainstream creditors or the companies creditors have sold their debt to. The reputations of mainstream creditors are at risk from such action by their agents.

The fees of trustees appointed by petitioning creditors were several times the amount on which the creditor's petition was made. Trustee fees in excess of \$100,000 were accrued for an original debt of \$4,000; \$70,000 for a debt of \$7,000; and \$58,000 when the original debt was \$5,000.

Consumer bankrupts felt frustrated and let down by the system when they found that

remedies available to them to query a trustee's fees are limited to independent taxation or taking the matter to Court. Both options are complex and expensive with costs being borne by the bankrupt in most instances.

Recommendations

1. That a review of trustees' fees is undertaken and the issues raised in this report be part of that review.
2. That the minimum debt on which a creditor's petition can be issued be increased from \$2,000 to \$10,000.
3. That an independent complaints/review process free of cost to bankrupts be established.
4. That the ITSA implement proactive strategies prior to and after consumer debtors become bankrupt.
5. That the IPAA address the issues raised in the report within its executive structure and with its membership.
6. That financial counsellors and community lawyers identify and document cases such as those in this report and bring these matters to the attention of other stakeholders.
7. That a roundtable of stakeholders including the Courts be facilitated by ITSA.

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INTRODUCTION

1.1 Consumer Debt

In Australia in the twenty first century, consumer credit is more available and easier to access than ever. Household debt levels are at an all time high as more consumers become financially overcommitted.

Some consumers on low incomes are unable to manage their way out of financial difficulty. Others with higher incomes but a higher level of debt cannot meet these commitments. Increased consumer spending, leads to increasing indebtedness, and to financial stress.

When people are unable to pay their debts this contributes to other problems including:

- non-payment and disconnection of utilities
- non-payment of rent and eviction
- mortgage arrears and sale of the family home by the mortgagee
- relationship problems, and
- mental and physical health problems.

Financial stress is a significant finding of research into the causes of relationship breakdown, family violence, mental and physical ill-health, suicide, and compulsive behaviour such as gambling.

1.2 Debtors' Options

While there are options available to debtors in difficulty, each has its own consequences.

These options include:

- challenging a credit contract where credit was provided unfairly or irresponsibly
- selling property
- obtaining help from family

- informal repayment arrangements with creditors
- options available under the Bankruptcy Act 1966 ("the Act").

Most bankrupts, especially those seen by financial counsellors have no assets at risk if they become bankrupt. These debtors become bankrupt on their own voluntary petition. They are **not** the focus of this project.

A small number of clients of financial counsellors become bankrupt when a creditor petitions for their bankruptcy. These debtors **are** the focus of this project.

ABOUT THE PROJECT

This project was initiated by the concern of financial counsellors and community lawyers where family homes were at risk due to the collection of small debts.

Factors which led to this risk to their homes included:

- a dispute about the original debt
- inaction by the debtor when threatened by bankruptcy
- creditors petitions to bankrupt debtors when other options for debt collection could have been used
- the impact of escalating trustee's fees once the debtor became bankrupt.

The project includes consultation with a range of stakeholders, and a review of case studies from financial counsellors and community lawyers. The primary focus of the project is to analyse existing information from Victorian financial counsellors and community lawyers about their clients' experiences.

The number of cases considered is small. Bankruptcies which arise from a creditor's petition rarely come to the attention of financial counsellors and community lawyers.

The project considers how and why debtors become bankrupt on a creditor's petition and the impact on them and their families.

- Can the equity in the homes of consumer debtors be better protected?
- Are there better debt collection alternatives to bankruptcy for consumer debtors?
- Can trustees' fees be minimised when consumer bankrupts' homes are at risk?

2.1 Project Objectives

This project aimed to produce a report which will:

- identify current practices affecting consumer bankrupts which are of concern to financial counsellors and community lawyers
- identify the process by which debtors with assets become bankrupt on a creditor's petition
- discuss the role of trustees as it relates to consumer bankrupts; and
- propose changes to address these problems.

The project further aimed to:

- inform stakeholders including the community services sector, Consumer Affairs Victoria (CAV), Victoria Legal Aid (VLA), the Insolvency Practitioners Association of Australia (IPAA), Insolvency and Trustee Service Australia (ITSA) and creditors of the issues faced by consumer bankrupts.

The project sought comment from:

- financial counsellors and community lawyers
- the Insolvency Practitioners Association of Australia (IPAA)
- creditors and their peak bodies
- the Insolvency and Trustee Service Australia (ITSA).

2.2 Undertaking the project

The project was undertaken by Jan Pentland, financial counsellor at Eastern Access Community Health (EACH) who represents consumer bankrupts on the Attorney General's Bankruptcy Reform Consultative Forum.

The project was assisted by consultation with a reference group of financial counsellors at EACH:

- Jackie Bramwell
- Peter Gartlan
- Carolyn Joy
- Kay Dilger
- Bernadette Douglas

The assistance of the Financial and Consumer Rights Council (FCRC) and member financial counsellors; and the Consumer Action Law Centre (CALC) is acknowledged.

In particular, the assistance of Paul Gillett, Director – Legal Practice, CALC for his research and writing of the Appendix is appreciated.

ABOUT CONSUMER BANKRUPTCY

3.1 Bankruptcy overview

The Commonwealth *Bankruptcy Act 1966* (the Act) is administered by the Insolvency and Trustee Service Australia (ITSA). In the context of the work of financial counsellors with consumer bankrupts, bankruptcy provides relief from financial difficulty and stress when debtors cannot meet their financial commitments.

Bankruptcy occurs in two ways: when a debtor voluntarily enters bankruptcy, or when a debtor becomes bankrupt through a Court process initiated by a creditor.

When a judgment debt of more than \$2,000 remains unpaid, a creditor can commence bankruptcy proceedings in the Federal Court or the Federal Magistrates Court. A Bankruptcy Notice is served on the debtor giving 21 days to pay the debt. If the debt is not paid in the specified time, a Creditor's Petition is served on the debtor. If the debt remains unpaid, the creditor applies to the court for a Sequestration Order against the debtor making him/her bankrupt.

The Annual Report on the operation of the Bankruptcy Act for 2005-06 (p 1.) reported that 91% of bankruptcies were debtor's petitions and 9% creditor's petitions; and that less than 10% of bankruptcies were due to business failure.

ITSA publishes a biennial profile of bankrupts. The profile of the 22,953 debtors who became bankrupt in 2005 states that:

- 69% had a gross income of less than \$30,000 in the year prior to bankruptcy
- 73% owed unsecured creditors less than \$50,000, 40% these debtors owed

less than \$20,000, and 20% owed less than \$10,000

- 86% had no realisable assets
- the two top causes of bankruptcy were unemployment (35%) and excessive use of credit (26%)
- 54% were unemployed; and
- 25% received advice from a financial counsellor.

Source: ITSA Profile of Debtors 2005

The profile of the large majority of bankrupts is that of debtors with a low income, low debt levels and few assets. In this report, these debtors are referred to as 'consumer bankrupts'.

Bankruptcy numbers have moved steadily upwards, with significant increases in 1991, and in the period 1996 to 1998. The largest number of bankruptcies (26,376) was recorded in 1997/98. In 2005/06 there were 22,299 bankruptcies, up from 20,501 the previous year. There are 25,242 bankruptcies provisionally recorded for 2006/07, an annual increase of 13.2% (www.itsa.gov.au). This is consistent with rising level of household debt.

Of the 21,812 bankruptcy administrations received by ITSA in 2005/06, 94.68% (20,652) were 'finalised', where finalised '...refers to administrations where all work necessary to be done has been completed, whether or not the bankrupt has been discharged' (p21, 2005 – 2006 *Annual Report by the Inspector General in Bankruptcy on the Operation of the Bankruptcy Act*).

3.2 Consumer bankrupts

Low income/low asset/low debt consumer bankrupts are the majority. In 2005: 69% of bankrupts had gross incomes of less than

\$30,000 per annum; 86% had no assets; and 73% owed less than \$50,000.

The clients of financial counsellors overwhelmingly have this profile. Voluntary bankruptcy for these debtors means that:

- most unsecured debts cannot be collected by creditors
- the stress caused by debt collection activity ceases
- no payments are required from a low income bankrupt's income
- necessary household goods cannot be taken and sold by creditors or the trustee in bankruptcy
- the debtor is released from payment of debts when discharged from bankruptcy.

Despite the stress of an untenable debt situation, and the relief that bankruptcy can provide, most debtors try to avoid bankruptcy and see it as a last resort. The disadvantages of bankruptcy include the stigma felt by some bankrupts, and the impact that bankruptcy can have on borrowing in the future.

Most bankruptcies are administered under Part IV of the Act. These bankrupts are usually discharged from their bankruptcy after three years. However, their bankruptcy is noted on their credit record for seven years, significantly affecting their ability to borrow; and on the National Personal Insolvency Index forever.

3.3 Financial counsellors

Financial counsellors work with low income, disadvantaged and vulnerable people. They provide an assessment of the debtor's overall financial situation, an explanation of the options available, support to debtors to implement their chosen option, and

advocacy including negotiating with creditors.

Financial counselling in Australia is largely Government funded with workers based in community agencies. Financial counsellors provide services which are:

- confidential,
- free of cost to debtors, and
- free of conflict of interest.

In 2005, 25% of bankrupts received information and advice from financial counsellors (*ITSA Profiles of Debtors 2005*). In his presentation to the ITSA Congress in Brisbane on 28 July 2006, the Inspector General in Bankruptcy, Terry Gallagher acknowledged the role of financial counsellors:

...when a debtor enquires about bankruptcy we do encourage them to consider the consequences of their proposed action and advise them of their alternatives. We strongly encourage them to go and speak to a financial counsellor.

The peak bodies for financial counsellors are the Financial and Consumer Rights Council (FCRC) in Victoria; and the Australian Financial Counselling and Credit Reform Association (AFCCRA) nationally. FCRC and AFCCRA give high priority to bankruptcy issues which are a fundamental and significant part of the work of financial counsellors.

This work includes casework issues, the policy and practice of ITSA and trustees, research on bankruptcy issues, and advocacy for appropriate legislative reform. FCRC has a Bankruptcy Working Group which meets bi-monthly with ITSA, and AFCCRA is represented on the Attorney General's Bankruptcy Reform Consultative Forum.

More information can be found at www.fcrc.org.au and www.afccra.org

3.4 Registered Trustees

A Registered Trustee ('trustee') is a private practitioner with accounting or legal qualifications who is licensed by ITSA to be a trustee in bankruptcy. The government trustee, the Official Trustee, by effect of s160 of the Bankruptcy Act, is the trustee in all bankruptcies where a registered trustee has not consented to act. In 2005/06 about 88% of new bankruptcies were administered by the Official Trustee. In the remaining 12% of bankruptcies a registered trustee nominated either by the debtor or a creditor is the trustee, providing he/she consents to do so.

The majority of bankruptcies 'finalised' (94.68% in 2005/06) do not require on-going administration. Of those bankrupt estates requiring on-going administration, at 30 June 2006 ITSA was administering 39% and trustees 61%. *(p.21 and 22, 2005 – 2006 Annual Report by the Inspector General in Bankruptcy on the Operation of the Bankruptcy Act).*

The Insolvency Practitioners Association of Australia (IPAA) is an independent, self-governing organisation which represents insolvency practitioners. The services the IPAA provides to members include: training, professional development, an industry journal, representation in appropriate forums such as the Attorney General's Bankruptcy Reform Consultative Forum, and on-going consultation with ASIC and ITSA.

In its 2005 annual report, the IPAA had 1350 members including registered trustees, accountants, lawyers, bankers, credit managers and academics. Most IPAA members are also members of the Institute of Chartered Accountants, the Australian Society of Certified Practising Accountants or the Law Societies in each state.

REGULATORY FRAMEWORK

4.1 The Bankruptcy Act and registered trustees

ITSA is the regulator responsible for administration of the Act reporting to the Federal Attorney General.

As set out in the *Bankruptcy Act* 1966 and the *Bankruptcy Regulations* 1966, ITSA's responsibilities include the registration of trustees in bankruptcy. These 'Registered Trustees' are then licensed by ITSA to undertake administration of bankrupt estates under the Act. They are regulated in these duties by ITSA. The Inspector General in Bankruptcy reported that there were 202 registered trustees in Australia at 30 June 2006, 44 were in Victoria (ibid).

Regulation of trustees aimed at "...ensuring high national standards of bankruptcy practice and procedure" is undertaken by ITSA's Regulation Branch. This includes the regulation of ITSA's own trustee function as the Official Trustee. The Regulation Branch acts independently and reports directly to the Inspector-General.

As part of its regulatory function, ITSA undertakes inspections of trustee administrations. In 2005/06 more than 80% of registered trustees were investigated. The outcome of these investigations shows a steady decline in errors identified.

ITSA received 211 complaints about trustees in 2005/06. Queensland had the highest proportion of complaints. Complaints in Victoria were proportionally consistent with other jurisdictions. Across Australia there were 184 complaints against registered trustees and 27 against the Official Trustee. Complaints about registered trustees increased by 34% (137 to 184) while

complaints against the Official Trustee fell slightly (from 31 to 27). After clarification of the complaints, 139 were investigated.

The four primary causes for complaint were:

- trustees' decisions around the disposal of assets (30%)
- lack of responsiveness when bankrupts sought information (19%)
- trustees' fees (17%), and
- delays in administration (5%).

The percentage of complaints found to be justified has substantially decreased from 26% in 2002/03 to 9% in 2005/06, reflecting '...a steady improvement in the standard of administrations generally' (p53, 2005 – 2006 *Annual Report by the Inspector General in Bankruptcy on the Operation of the Bankruptcy Act*).

4.2 Regulation of trustees' fees

At common law and under statute, a trustee in bankruptcy is entitled to be reimbursed out of the trust estate in respect of all costs, charges and expenses properly incurred by the trustee in performing duties as trustee.

However, there are rules governing the nature and quantum of such fees, and the trustee must abide by certain principles in performing his or her duties – see Appendix.

At common law, a trustee must:

- a) administer the estate in the interests of the creditors and the bankrupt
- b) exercise judgment so as to save the estate unnecessary expenditure of money
- c) maximise the return from estate assets, and thereby maximise satisfaction of the creditors' claims and any possible surplus for the bankrupt; and

- d) claim remuneration only for work reasonably and bona fide undertaken for the purpose of administering the estate or performing any public duty imposed by the Act, conformably with the trustee's duty to perform the work with reasonable care and skill and in an efficient and economical way.

Under statute, a trustee must:

- e) administer the estate as efficiently as possible by avoiding unnecessary expense: s 19(1)(j) of the Act; and
- f) exercise powers and performing functions in a commercially sound way: s19(1)(k) of the Act
- g) before deciding whether it is appropriate to incur a cost, compare the amount of the cost likely to be incurred with the value and complexity of the administration: Reg 2.13(b) of Schedule 4A of the Bankruptcy Regulations.

Further, Division Four of Part Eight of the Act sets out mechanisms for review of trustees' conduct. Sections 178 and 179 provide for the right of a bankrupt, creditor, or any other person affected by an act, omission or decision of the trustee, to apply to the Court to make such order in the matter as it thinks just and equitable, including removing the trustee from office.

Regulation 8.09 provides for taxation of trustees' bills of costs. A taxing officer must satisfy him or herself that 'the employment of the person in respect of the particular matters out of which the costs arise was duly authorized and was reasonable and necessary'. A taxation may be subject to review by the Federal Court of Australia.

THE RESEARCH

The focus of this project is an examination of cases from financial counsellors and community lawyers where a family home was at risk through a creditor's petition to bankrupt a debtor. Financial counsellors rarely deal with cases where a debtor becomes bankrupt on a creditor's petition. Their primary role in bankruptcy is with consumer bankrupts with no assets who become bankrupt on their own voluntary petition.

The minimal experience financial counsellors have with bankruptcy other than voluntary petitions occurs when a debtor who became bankrupt on a creditor's petition finds their way to a financial counselling service or a community legal service. Hence, while the number of cases outlined in this report is small, they merit attention beyond their number as indicators of issues to be considered by the bankruptcy regime.

The following cases highlight some of the problems which came to the attention of financial counsellors and community lawyers.

Case 1

A debtor became bankrupt on a creditor's petition. This action was taken by a debt collector acting for the creditor on a debt of less than \$7,000. The debtor had been making agreed repayments but was unable to maintain them when he became unemployed. When the bankrupt and his family realised the risk to their family home, they vigorously opposed action to sell it. The appointed trustee accumulated fees of more than \$70,000. A financial counsellor and community lawyer became involved. When alerted to the risk to its reputation, the

creditor resolved the matter by paying the fees of the trustee and releasing the debtor from his liability. The creditor did not recover the original debt which led to the bankruptcy.

Case 2

A creditor's petition for a debt of less than \$5,000 was issued to a disability pensioner. The petitioning creditor had bought the debt from a mainstream lender. There was \$160,000 equity in the debtor's home. Action by a financial counsellor and community legal service stayed the bankruptcy proceedings while the mainstream creditor was notified of the matter. When alerted to the risk to its reputation the creditor bought back the debt and released the debtor from his liability.

Case 3

An elderly woman and her husband fully owned their home. The couple's English was minimal. The husband owed \$8,000 on a credit card. A debt collector acting for a mainstream creditor issued a creditor's petition despite a belated attempt to pay the debt. A trustee was appointed and accumulated \$27,000 in fees. When the children became aware of the situation and the threat to the family home, they strongly advocated with the mainstream lender to settle the original debt, and the bankruptcy was annulled.

Case 4

When her husband died, an elderly migrant woman owed \$7,000 to a funeral parlour. She fully owned her home but her only income was the aged pension. She did not understand the threat to her home when she

was unable to pay the debt. The debt was referred to a debt collector and she became bankrupt on a creditor's petition. A trustee was appointed. Confused, the woman refused to fill in the Statement of Affairs and trustee's fees of \$37,000 quickly accrued. Eventually the house was saved when family members became aware of the situation, paid the debt and the trustee's fees.

Case 5

A debtor became bankrupt on a creditor's petition for a debt of less than \$5,000. A trustee was appointed. The debtor had \$65,000 of equity in his home and arranged a \$40,000 second mortgage to pay his debts. When he and his father met with the trustee for the first time, he offered to pay out all the debts and the trustee's fees to that date. The trustee told him 'it doesn't work that way'. The bankrupt's transaction account with a balance of \$600 for living expenses was frozen. The bankrupt was extremely stressed by his situation and unable to work. The matter dragged on and the money from the second mortgage was used on medical and living expenses. With intervention from a financial counsellor who challenged the basis of the debt and how it had been managed, the creditor agreed to an annulment of the bankruptcy and released the debtor from his liability. Further, the creditor acknowledged its poor handling of the debt collection and paid the trustee's fees of \$58,000.

Case 6

Following a car accident, the debtor owed \$16,000. The solicitor acting for the owner of the other car issued a creditor's petition. The debtor became bankrupt and a trustee was appointed. There was \$70,000 of equity in

her home but payment of the debt and the trustee fees exceeded that amount. The house was sold. Her transaction account with a balance of \$7 was frozen.

Case 7

A disabled woman owned her own home. She was served with a creditor's petition on a Judgment debt of less than \$5,000. The debt had been sold by a mainstream lender and the assignee became the petitioning creditor. The debtor had made a repayment proposal to the creditor but this was not accepted. Action by a community legal service involving the mainstream lender and the assignee resulted in the bankruptcy petition being withdrawn, costs being waived and the original repayment offer being accepted.

Case 8

A disability pensioner with \$100,000 equity in her home became bankrupt on a creditor's petition. She owed \$2,000 to a single creditor, and disputed the debt. The appointed trustee claimed \$45,000 in fees. The house was sold. The debtor received less than half of the original equity in her home after the debt and the trustee's fees were paid.

Case 9

A migrant woman owed \$8,000 to a mainstream creditor. A debt collector acting for the creditor issued a creditor's petition and she became bankrupt. The family home where she was on title with her husband had \$60,000 of equity. Her overall debts in the bankruptcy were \$25,000. The husband refinanced the home, negotiated with the creditors and paid out the debts. The trustee claimed \$18,000 in fees.

Case 10

A debtor owing \$2,500 became bankrupt on his own voluntary petition after receiving poor advice from a friend. A trustee was appointed. The bankrupt negotiated with the creditor and paid the debt leaving the trustee's fees of \$12,000 to be paid. The trustee claimed an equitable interest in a property which had been owned solely by the wife prior to and since the marriage. When the claim was queried, the trustee said that there would be a substantial escalation of costs if the wife queried the trustee's claim. The wife agreed to pay the trustee to prevent any further escalation of his fees despite being confident that her husband was not entitled to equity in her house. A community lawyer who became involved was instructed by the wife not to pursue the matter due to the risk of fees escalating.

Case 11

After a successful workcover claim, a woman was to receive \$75,000 within days. She advised the creditor who was owed \$16,000 and an undertaking was given that debt collection action would be put on hold. However, a creditor's petition was issued, she became bankrupt and a trustee was appointed. The debts were quickly paid, and the bankruptcy annulled but \$12,000 in trustee's fees accumulated.

Case 12

A mainstream lender sold a credit card debt to a debt collector. The debtor received a *'Notice of intention to commence Bankruptcy proceedings'* when she became unemployed and could not maintain her repayment arrangement. The assignee told the financial

counsellor acting for the debtor that its common practice where a debtor is on title of a property is to issue a creditor's petition. Intervention by the financial counsellor persuaded the assignee to consider an alternative to a creditor's petition.

Case 13

A debtor's business failed and a business creditor was owed \$29,000. Most of the debt (\$25,000) was paid but the solicitor acting for the creditor issued a creditor's petition on the remaining \$4,000 debt. The total debts owed in the bankruptcy were less than \$20,000. Trustee's fees of more than \$100,000 accrued and the bankrupt's family home was sold. The bankrupt explored several avenues to challenge the trustee's fees including employing his own solicitor. This added to his own and the trustee's fees which were then paid from the sale of his home. The bankrupt expressed the belief that the solicitor continued with the creditor's petition due to his relationship with the trustee. When the petitioning creditor was contacted about the outcome of the bankruptcy he was dismayed that the bankrupt had lost his home due to the \$4,000 debt.

RESEARCH FINDINGS

The research considered more than twenty cases from financial counsellors and community lawyers. Thirteen cases are outlined above. Those cases involved risk to a family home.

Of the cases not outlined in the report, three related to the trustee's right to a minimum fee of \$1444 where there are no proceeds from the bankrupt's estate. While most trustees do not pursue this entitlement from impecunious bankrupts, some do and one issued legal proceedings to recover the \$1444.

The original debts on which creditors issued petitions were small. A debt of less than \$10,000 led to bankruptcy or threat of bankruptcy in 10 of the 13 cases. The fees of the appointed trustees were several times the amount on which the creditor's petition was made. The extremes were trustee fees in excess of \$100,000 for an original debt of \$4,000; \$70,000 on a debt of \$7,000; and \$58,000 when the original debt was \$5,000.

Factors leading to the homes of consumer bankrupts being put at risk include:

- the actions of debtors themselves
- the actions of creditors, and
- Trustee's fees.

6.1 Action of the debtor/bankrupt

In many of the cases in the project, the debtor contributed to the creditor's decision to petition for bankruptcy. There are a number of steps in the legal process for a creditor to bankrupt a debtor. Often to their own detriment debtors do not respond effectively to debt collection action including progression to legal action and bankruptcy proceedings.

In some cases, debtors' lack of action was due to a dispute of the original debt; and/or a breakdown of negotiation with the creditor to pay the debt; and/or the debtor being unable to come to a repayment arrangement due to financial hardship. In some instances, the debtor ignored debt collection action hoping it would go away.

However, in the large majority of the cases in the report these debtors were vulnerable in a range of circumstances including that they had limited literacy skills; they were elderly; their first language was not English; they were suffering physical and/or mental illness; they were experiencing difficult life situations. In most cases they did not understand the bankruptcy process and its implications; and often when they tried to clarify it, the system let them down.

Most debtors were not aware of the cost implications of a creditor's petition to bankrupt them and the risk to their assets, usually their home. Once they become bankrupt a process was set in train where costs are likely to be substantial. Trustees are obliged to ensure that debtors as well as creditors understand how the trustee's fees will be calculated and costs incurred. While the intention of many trustees is that debtors **do** understand this, most of the debtors in this project did not.

In many cases, the initial work undertaken by the trustee would have exceeded the original debt owed. With further work the trustee's fees escalated to several times the original debt. Consumer bankrupts contributed to escalating trustee fees in several ways. They made inquiries of the trustee, and/or challenged actions of the trustee, including the trustee's fees.

Often a deteriorating relationship between the bankrupt and the trustee exacerbated the

situation. Several of the bankrupts sought information or clarification from ITSA, or made complaints. They felt frustrated and let down by the system when they found that remedies available to them to query a trustee's fees are limited to independent taxation or taking the matter to Court. Both options are complex and expensive with costs being borne by the bankrupt in most instances.

6.2 Action of creditors

In many of these cases bankruptcy was used to collect a debt when an alternative was available. A Warrant of Seizure and Sale rather than a creditor's petition would have been a cheaper and less cumbersome option.

The courts have questioned the efficacy of creditors' petitions when there were alternatives as in *Vaucluse Hospital v Phillips* (2006).

There is no evidence before me as to why the creditor did not simply move to recover the judgment debt as against the interest of the respondent in the home that he jointly owns with his father and brother. The process is relatively straightforward and relatively inexpensive.

From the experience of financial counsellors it is not the usual practice of mainstream creditors to bankrupt debtors. This is a realistic commercial decision given the cost of taking that action, and doubt of full payment of their debt when the trustee's fees and the claims of other creditors are taken into account. In four of the report's cases, the creditor did not receive payment of the original debt.

A creditor's petition was more likely where creditors outsourced debt collection or sold debts. In some instances these creditors were not aware of the action taken by their agent or assignee to issue a creditor's petition. Some creditors were genuinely concerned

when they became aware of the risk to family homes due to the collection of their small debt.

In most cases where a financial counsellor or community lawyer intervened, the original creditor acted to resolve the matter. Two mainstream creditors have reviewed their policies and practices to address their concern about the use of bankruptcy to collect small debts. This action is driven by potential risk to their reputations.

While most creditors do not turn to bankruptcy to collect consumer debt the creditor in case 11. chose to bankrupt the debtor despite confirmation that the debt would soon be paid. In case 12, the assignee stated that it is their **usual** practice to issue a creditor's petition when a search finds a debtor on title of a property.

6.3 Trustee's fees.

A trustee is appointed when a debtor becomes bankrupt on a creditor's petition. Fee charging for the administration of the bankrupt's estate commences at that point, and costs accumulate depending on the work undertaken in the administration, and the seniority of staff involved.

Where debtors are made bankrupt on a creditor's petition, Section 19(1) of the Act charges trustees with:

- j) administering the estate as efficiently as possible by avoiding unnecessary expense
- k) exercising powers and performing functions in a commercially sound way.

The amount of the trustee's fees is of particular concern when the bankrupt's home is put at risk. In many of the reported cases, the equity in the home considerably exceeded the bankrupt's liabilities. Much of

the residual equity was lost through the trustee's fees. Under the Act trustees are obliged to act in the interests of creditors **and** debtors. Preservation of as much equity as possible in family homes is an optimum outcome.

When they became bankrupt on a creditor's petition, it could be argued that most of the debtors in this report were solvent where solvency is defined as having realisable assets which exceed liabilities. In *Vaucluse Hospital v Phillips* (see Appendix) the court questioned the use of bankruptcy where the debtor's assets exceeded liabilities, restating the principle established in prior judgments:

Aside from the fact that the bankruptcy scheme is intended for those who are insolvent, this principle protects against a potential practical problem that could develop of trustees feasting on the assets of solvent estates.

When considering the duties of a trustee, the court observed that:

In many cases there is a significant difference between cautiously carrying out the minimum steps required under the legislation, and a much more active and interventionist pursuit of the estate. There are obvious indicators of cases where a cautionary approach is appropriate, such as:

- a) the sequestration order is made with respect to a relatively small debt;*
- b) the sequestration order is made in the absence of the bankrupt;*
- c) the debt is not incurred in the course of business or commercial dealings; and*
- d) the bankrupt appears to have significant assets, such as a home.*

These indicators were present in the majority of cases considered in the report.

A significant contributor to the level of trustee's fees is lack of competition. In his address to the 2006 ITSA Congress, Inspector-General Terry Gallagher confirmed that the choice of a trustee:

...is involuntary for most creditors:

- if it is a sequestration order the petitioning creditor has a choice however that creditor has no power to negotiate fees; and other creditors have not been involved in the selection*
- in the case of a debtor's petition, and the petitioner comes with a consent, it is the debtor who chooses. Of course creditors can change the trustee but that is often costly and disruptive.*

He argued that there is a lack of the usual commercial dynamic in regard to trustee remuneration:

In a bankruptcy administration the trustee controls the funds and property out of which fees are taken. Whilst the trustee must satisfy themselves that fees taken are in accordance with approvals, this contrasts with the manner in which a more typical commercial service provider would seek and obtain payment.

As the Official Trustee, ITSA administers almost all consumer bankruptcies, most of them being 'finalised' quickly. These bankrupt estates deliver no returns to creditors and ITSA bears the cost of administration. There is no competition for administration of these estates.

Of the bankruptcies where there were on-going administrations on hand at 30 June 2006 4,177 (39%) were being administered by ITSA and 10,682 (61%) by trustees.

In 2005/06 \$111,764,886 was received by registered trustees. Of this, \$24,730,777 (22%) was trustee remuneration; \$19,920,678 was dividends paid to creditors (18%). Other payments (53%), mostly legal costs and payments to secured creditors was \$59,566,706 (*p16, 2005 – 2006 Annual Report by the Inspector General in Bankruptcy on the Operation of the Bankruptcy Act*).

The scale of fees in one case ranged from \$450 per hour for the trustee to \$90 per hour for a clerk. Fees are then calculated depending on who undertakes the work. In

this case 86.8 hours of work on the administration was costed at \$20,815, an average of \$239.8 per hour. The debt on which the creditor's petition was issued was less than \$5,000.

In another of the cases, the bankrupt reported her trustee telling her that meeting with him was costing her \$900 an hour. Acting in the interests of the debtor as well as the creditor, is the involvement of two senior staff justified?

DISCUSSION

This project looks at the small percentage of bankruptcy matters involving a creditor's petition which come to the attention of financial counsellors and community lawyers. In particular, the risk to the home of consumer bankrupts is a concern. ITSA also deals with complaints where the effect of creditors' petitions and trustee remuneration leads to sale of the bankrupt's home.

At the ITSA Congress in 2006, Terry Gallagher the Inspector-General in Bankruptcy presented a hypothetical case scenario of a complaint about trustee's costs coming to ITSA through a local Member of Parliament.

- A small business man in the MPs electorate became bankrupt on a creditor's petition for a disputed debt of \$20,000.
- The trustee is about to sell the bankrupt's property to the value of \$400,000 to meet his fees and the expenses of the estate.
- ITSA's Bankruptcy Regulation investigates the matter.
- The trustee responds that the bankrupt has been uncooperative, and the estate requires additional work by the trustee, thereby escalating the fees.
- Bankruptcy Regulation determines that the trustee's fees are valid. The work was undertaken by the trustee and he is entitled to be paid.

The Inspector-General then commented that:

The problem with this story is that it's not an exaggeration. There are too many of these very examples. And while we might satisfy ourselves that work was done and professionals are entitled to be paid, when you stand back and look in – as an ordinary citizen would and should – it simply does

not add up. You do have to ask yourself the question ... "How can we have produced a system that allows this to happen?" Public confidence can be undermined in many ways.

Financial counsellors and community lawyers agree that such an outcome should be questioned. The focus of this report is on consumer bankruptcies where family homes are at risk or lost. Ordinary people do not understand how the use of bankruptcy to collect small debts can produce this outcome.

While debtors themselves contribute, the actions of creditors and trustees play the significant part. What strategies can be considered to reduce the number of such cases?

7.1 What can financial counsellors do?

Financial counsellors have a preventative role. When debtors are considering a voluntary petition for bankruptcy financial counsellors undertake a thorough assessment including identifying any assets which may be affected. They inform debtors of the full range of options which can be used to collect debt including a creditor's petition for bankruptcy. The implications for the debtor's assets are explored and explained.

As well as assisting debtors to understand the implications of bankruptcy on their assets, financial counsellors can advocate for debtors with petitioning creditors, and/or their agents and assignees. A creditor's petition may not be in the best interests of any party.

Once a debtor becomes bankrupt on a creditor's petition, financial counsellors and community lawyers may be constrained in questioning or challenging trustee actions as

this is likely to add to the trustee's fees. However, in some cases in this report such action has seen creditors' petitions withdrawn, bankruptcies annulled, repayment proposals accepted, and debtors released from liability.

Financial counsellors and community lawyers can continue their work with individual clients, and in broader advocacy to address systemic problems. An area for advocacy is the accepted practice in the financial services sector that consumers have a right to a dispute resolution process which is free and independent, eg the Banking and Financial Ombudsman Service.

7.2 What can creditors do?

Creditors can actively consider alternatives to bankruptcy when collecting small debts. They can monitor the use of bankruptcy by their agents and assignees. Mainstream creditors are aware of the risk to their reputation and some have taken action to ameliorate it. Service agreements with agents and assignees can be reviewed and more closely monitored.

Once a debtor is bankrupt on a creditor's petition, creditors could consider more carefully who they nominate as trustee, and be more vigilant in monitoring the trustee's fees. In most of the cases in this report the bankrupt's assets significantly exceeded liabilities. Often it was the trustee's fees which eroded the remaining equity in the bankrupt's home.

A contributor to high trustees' fees is limited competition. The creditor or agent may be influenced to appoint trustees with the reputation of aggressively pursuing the bankrupt. In some bankruptcies where a rigorous investigation is required to identify assets and maximise returns to creditors, this is justified.

However, consumer bankrupts are unlikely to require this level of investigation. Cases in this report show that when high fees are charged in the administration of a consumer bankrupt's estate, creditors may get little or nothing but the effect on the bankrupt's home is disproportionate to the debt being collected.

7.3 Do the courts have a part to play?

Courts have expressed concern about the effect on debtor's homes due to sequestration orders. When a creditor petitions the Federal Court to bankrupt a debtor, and it seems that the debtor's realizable assets exceed the debts, the Court could stay the proceedings while the debtor was referred to an independent third party. Representations by community legal services in two of the cases considered in this report avoided the debtor's bankruptcy.

7.4 What can the IPAA do?

It is acknowledged that the actions of bankrupts themselves contribute to the work of trustees and therefore to trustees' fees. However, action by the trustee also significantly contributed to a deterioration of the relationship with most of the bankrupts in this report. The Act charges trustees to act in the interests of creditors and bankrupts, but this was not the felt experience in these cases.

Communication is key to professional practice, and the responsibility for establishing effective communication is primarily with the trustee as the professional. A clear and simple explanation of the rights and responsibilities of the bankrupt and the trustee; the administration process; and cost implications may facilitate

a less stressful and onerous outcome for both the bankrupt and the trustee.

Generally, such an outcome would lessen the trustee's fees and may provide a better outcome for creditors as well as for debtors. In the research, instances were reported where trustees developed good relationships with bankrupts and their actions minimised fees. In particular instances, work by trustees was delayed to allow time for the family or others to find solutions.

There is risk to creditors' reputations when bankruptcy is utilised inappropriately. Similar risk is present for the insolvency profession when the behaviour of some trustees brings the profession into disrepute. Trustees are reminded of the requirement under the Act to act in the interests of bankrupts as well as creditors. This would go some way towards addressing the perception that some trustees act primarily in their own interests.

The IPAA Code of Professional Practice is currently being reviewed and includes a section on 'Guidance – Remuneration' (p53) The IPAA has a role to play as the professional association for insolvency practitioners through implementing such codes, through its training and professional development activities, and by encouraging its members to improve their relationships with consumer bankrupts.

7.5 What can ITSA do?

As the bankruptcy regulator, part of ITSA's role is to encourage debtors to consider alternatives to bankruptcy. This role is largely undertaken by providing information when a debtor is considering lodging their own voluntary petition. Where the petition is presented to ITSA and the debtor's Statement of Affairs indicates assets exceeding debts, Official Receivers could

exercise their right to reject or delay a debtor's petition and refer the debtor for independent advice from a financial counsellor.

Where debtors who have or have had assets bankrupt on their own petitions, an ITSA assessment may determine that there is little likelihood of a dividend to pay trustees' fees or creditors. ITSA usually retains the administration of those estates. This generally benefits trustees as well as debtors. It also addresses the potential problem of trustees actively pursuing payment of the minimum fee under Section 161(b) of the Act.

Where the debtor becomes bankrupt on a creditor's petition, ITSA's opportunity to intervene is later in the process, after the debtor is already bankrupt. The intention then would be to expedite administration of the bankrupt's estate and minimise trustee's fees. The Inspector-General in Bankruptcy commented at the 2006 ITSA Congress on the benefit of earlier intervention by the regulator:

As much as is possible, the system and our role in it, is about avoiding problems and addressing them as early as possible. Being proactive – rather than just picking up the pieces at the end – being reactive. Of course, we're not always successful and inevitably in this business we find ourselves just picking up the pieces from the financial catastrophe.

With 80% of trustees being investigated by Bankruptcy Regulation (BR) in 2005/06, ITSA takes a proactive role in monitoring the practices of trustees. However, its oversight of trustees' fees is not proactive and is usually triggered by a complaint from a creditor or a debtor. The complainant is then advised to access taxation of the trustee's remuneration or go to Court. Either of these options can be costly and out of the reach of the bankrupt.

The Inspector-General has suggested that ITSA can be more proactive on trustees' remuneration as part of its Bankruptcy Regulation role.

We can, I think, be more alert when inspecting files to:

- *evidence of fees mounting; and*
- *evidence of relations between debtor and trustee deteriorating.*

We could, I suggest, invite trustees to involve BR earlier when they observe a problem looming.

We could even require trustees to advise ITSA at the outset in high risk cases.

When ITSA becomes aware of problems later in the process, resolution is likely to be more difficult due to entrenched positions of creditor, debtor and trustee; and fees are likely to have escalated significantly. For consumer bankrupts this may lead to the outcomes in our case studies, and in the scenario presented by the Inspector-General to the Bankruptcy Congress, i.e. the risk to or loss of the bankrupt's home.

CONCLUSION

Financial counsellors and community lawyers rarely see bankruptcies involving a creditor's petition. While the number of cases examined in this project is small, they merit attention beyond their number. ITSA and the Attorney General also receive complaints about trustees' fees.

In *Vaucluse Hospital v Phillips* (2006) FMCA 44 the court questioned the use of bankruptcy to collect small debts. Creditors can petition for bankruptcy to collect debts as small as \$2,000. Despite debt levels increasing exponentially, this amount has not been reviewed or indexed.

A creditor's petition triggers a process which can significantly impact on the homes of debtors and their families. Mainstream creditors are currently paying more attention to the development and implementation of financial hardship policies for debtors in financial difficulty. Attention to responsible collection of debt beyond this stage would be welcomed by financial counsellors. Using the bankruptcy regime to collect small debts should be a last resort.

When debtors are forced into bankruptcy, trustees' fees for the administration of their estates further diminishes equity in their homes. The legal principles to query trustees' fees are not operating as intended. Bankrupts lack the financial resources to pursue what remedies are available, even if they identify and understand the process of doing so.

Any such challenge increases the bankrupt's costs and diminishes any surplus. Circumstances in which the bankrupt and/or family can refinance their mortgage or recover any surplus from the sale of their home become increasingly remote. Financial counsellors and community lawyers

reported constraint in querying a trustee's actions in view of the risk of escalating the trustee's fees.

How can the rights of creditors and the integrity of the bankruptcy regime be retained **and** the needs of consumer bankrupts and their families be addressed?

Should the cost of a bankrupt's inquiries or challenges be added to the trustee's fees, and therefore paid from the bankrupt's estate? It is now accepted practice in the financial services sector that consumers have a right to a dispute resolution process which is independent and free to complainants, eg the Banking and Financial Ombudsman Scheme.

Early intervention by ITSA is key to better outcomes for consumer bankrupts. Acting more proactively, ITSA as the Government regulator, could take on a mediation role as an independent third party. ITSA has identified indicators which point to high risk cases and the need to intervene. The Courts have also identified indicators where the use of creditor's petitions can be questioned.

Trustees and the IPAA, as the industry association have a major role to play, as do creditors. Efforts can be made by both creditors and trustees to contain costs of collecting small debts where a bankrupt's home is at risk. Involving independent advocates such as financial counsellors and/or ITSA as an independent mediator are options to consider.

This project asks:

- Can the equity in the homes of consumer debtors be better protected?
- Are there better debt collection alternatives to bankruptcy for consumer debtors?

- Can trustees' fees be minimised when consumer bankrupts' homes are at risk?

If the answer to these questions is 'yes', this project can add to a constructive discussion towards achieving better outcomes for debtors, bankrupts, creditors, trustees and ITSA.

In many of the cases in this report debtors lost or were at risk of losing their homes due to creditor's petitions on small debts. The ordinary citizen may well ask *"How can we have produced a system that allows this to happen?"*

RECOMMENDATIONS

1. That a review of trustee remuneration is undertaken and the issues raised in this report be part of that review.
2. That the minimum debt on which a creditor's petition can be issued be increased from \$2,000 to \$10,000.
3. That an independent complaints/review process free of cost to bankrupts be established.
4. That the ITSA implement proactive strategies prior to and after consumer debtors become bankrupt.
5. That the IPAA address the issues raised in the report within its executive structure and with its membership.
6. That financial counsellors and community lawyers identify and document cases such as those in this report and bring these matters to the attention of other stakeholders.
7. That a roundtable of stakeholders including the Courts be facilitated by ITSA.

APPENDIX

Bankruptcy Act and Trustees' Fees

Paul Gillett, Director – Legal Practice, Consumer Action Law Centre.

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