

# Adjudicated Debt Resolution (ADR): A Proposal for a Cooperative Approach to Resolving Debt Issues

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## Preamble

Debt is an essential ingredient in Australia's economy. It fuels a level of consumption, which is essential to absorb ever-growing production. The inability to repay debt is the most significant internal social issue confronting Australians today.

The Reserve Bank of Australia reports that the level of consumer debt in November 1998 was approximately \$12b AUS. In November 2002, this had risen alarmingly to \$21b AUS. By June 2003, the level was \$24b AUS and topped \$25b AUS in September 2003.<sup>2</sup>

At this time of rising household and commercial debt, disposable incomes are being eroded and most people are struggling to meet their commitments let alone create savings.

## Debt is not about money; it is about people and the impact it has on their lives.

Financial pressure is an ingredient in many stress related illnesses including anxiety and depression. It is commonly a factor in relationship failures and even more terribly in cases of domestic violence, addictive behaviours, crime and, tragically, suicide.

*I believe that a truly advanced and compassionate society would hold a single human life infinitely more valuable than the sum of that person's debts.*

Without doubt the human cost of debt distress is dreadful but so too are the commercial costs. Bad debt is wasteful and costly. Not only is there the immediate loss of revenue from the failed account, which may occasion borrowings to replace other hidden costs mount up too. Administration costs to manage the failed account; legal costs of recovery proceedings; opportunity cost associated with assigning assets to non income producing functions; and the often overlooked cost of replacing the lost customer. Typically, the economic loss is magnified up to threefold. These costs are not absorbed but rather passed on the consumer in higher pricing.

## Being in debt is not a problem, being unable to repay is.

After more than 5500 domestic and commercial case studies, I understand that people do not plan to place themselves in financial difficulty. It is simply preposterous to suggest that a person would elect to take a course of action guaranteed to subject them to the torment and ridicule of what passes for debt collection practice today.

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1. Managing Director, Debt Helpline Pty Ltd.

2. Reserve Bank of Australia, Bulletin Statistical Tables, Payments System (C Tables), Credit and Charge Card Statistics – C1.

Nor can any credence be given to the notion of 'excessive use of credit'. Credit is given, not taken. You cannot demand to be given credit. The corollary to the suggestion of excessive use of credit must surely be the excessive provision of credit. Credit providers hotly refute this suggestion. They contend that they only advance credit to the extent that they judge it prudent to do so. They can demonstrate that they assess each applicant's circumstances before agreeing to extend credit. At law sanctions have been introduced in the Uniform Consumer Credit Code, to ensure proper lending practices are followed.

No, the fact is that an inability to pay is attributable to *force majeure*, that is, factors or forces outside the sphere of influence of the debtor, which undermine his or her capacity to service debt. The most common causes are listed below:

- Bad debt, for example:
  - the failure of a debtor; and
  - being called on to satisfy a guarantee.
- Change in personal circumstances, for example:
  - loss of employment or reduction in income level;
  - ill health prevents income generation; and
  - divorce or separation removes assets or creates distraction.
- Change in market conditions, for example:
  - increased competition;
  - decreased demand; and
  - obsolescence.
- Change in environmental factors, for example:
  - flood, fire or famine;
  - change in law; and
  - changes in overall economic conditions.
- Fraud:
  - embezzlement;
  - theft; and
  - defrauding.

This logic is borne out by experience. Any and every individual or organisation is susceptible to financial problems. By virtue of waking and participating in the real world or opening for business every day, each of us is exposed to the vagaries of circumstance. For this reason we all should be concerned to develop practices for dealing with debt which we would be comfortable with if applied to us.

### **The harmful consequences of debt result from how it is handled.**

You cannot eradicate debt distress by shielding people from credit or commercial risk. This would not only be patronising it would be economically disastrous. To the contrary, the way forward is to accept the inherent risk associated with financial and credit transaction and to find better ways to resolve the inevitable failures. Ways that will reduce both the financial and human costs but prove no less effective.

This paper argues that introducing adjudication and arbitration as the alternative to litigation is that better way.

**The current procedure for recovering a civil debt in Australia is regimented and procedural.**

Creditors must go to Court to prove their claim and enforce judgment against a debtor's assets or income. Civil recovery procedure is only effective if the debtor has a repository of funds or assets from which payment can be made.

Regrettably, in the haste to escalate collections into the realm of the Court in the hope that this will increase pressure on the debtor to pay, creditors seem to overlook the threshold question, does the debtor have either the surplus assets or income from which to effect payment?

Civil recovery procedure is ineffective in circumstances in which the debtor cannot pay his or her debts because he or she is impecunious.

Equally counter productive is the propensity for debtors to use the civil recovery process to delay and frustrate a creditor who is justly entitled to recover quickly against the debtor.

**Civil recovery procedure seeks to lay blame and fans conflict.**

In accepting the impact of *force majeure*, it is then possible to debunk the cornerstone of our debt collection systems, the view that the creditor enjoys the moral high ground. From this rectitude appears to flow the justification for the bullying and intimidations that characterise debt collection activity today.

This view, though traditional, is as obsolete and inaccurate as the concept of 'excessive use of credit'. Why? In any credit transaction there are two or more parties who agree certain facts. The debtor, in accepting the credit extended, believes that his or her circumstances will always enable him or her to repay their debts. The creditor assesses the same facts and must draw the same conclusion. Both are taking a calculated risk that force majeure will not intervene in this speculation. The risk is equally shared.

In the event that force majeure does intervene, the responsibility for the consequence is equally shared. An improved system for the handling of debt issues should adopt the cornerstone that each party shares a common risk and therefore equal culpability for their respective outcome.

**Civil recovery procedure is selfish.**

Proceedings are brought by the creditor against a debtor. Because the Court will only make a determination in respect of the parties to the action, any outcome obtained will exclude the interests of other creditors. This is inequitable if not unjust.

A new system should identify all current creditors and existing creditors as stakeholders. It should produce outcomes that are equitable to all stakeholders.

### **Federal laws provide guidance on a better approach.**

There is law governing circumstances where the debtor cannot pay. The Federal insolvency laws embodied in the *Bankruptcy Act* and the *Corporations Law* provide for the fair and compassionate treatment of debt matters. Three key principles evident in both Laws are of interest here:

1. These laws are inclusive. The interests of all persons (including corporations) who are creditors or contingent creditors of a debtor are considered. Creditors participate in the process and share in the available funds. To do so, creditors have their right to sue for their debts converted into a right to share in the proceeds (dividend) paid from the insolvency.
2. Discourage the payment of undue preferences. This deals with the situation where a debtor pays a creditor in the six months preceding either bankruptcy or liquidation, an amount which is greater than the amount the creditor would have received in a distribution had the debtor been under an insolvency administration at the time of the payment. This principle extends to encompass any benefit received by a creditor in consequence of the execution of judgment. This is quite deliberate and makes it clear that in circumstances where there is simply not enough money to pay all creditors, all creditors should be treated equitably. It makes it clear that using the civil recovery procedure to gain a priority over other creditors is not desirable.
3. Both federal laws provide mechanisms for debtors and creditors to compromise in circumstances where compromise will maximize the return to creditors. Parts IX and X of the *Bankruptcy Act*, and Part 5.3A of the *Corporations Law* prescribe legislative schemes to arrive at a cooperative en-globo resolution to a debt problem. While these legislative schemes are prospectively very beneficial to both debtor and creditor alike, in practice their effectiveness is often undermined by their procedures. Both schemes use a ballot of creditors to determine by majority whether or not to accept the offer of compromise put forward by the debtor. This process ignores the influence of emotion in the relationship between debtor and creditor. Hence, it is common for sound proposals to be rejected because of enmity between debtor and one or more creditors. This not only occasions an uncommercial outcome but an unjust one for creditors not involved in the conflict that gave rise to the enmity.

The Bankruptcy Law also operates to safeguard certain minimum standards of living for debtors by isolating items as non-divisible property, that is, property not available for distribution among creditors. Such property includes, *inter alia*, essential personal effects, clothing and furnishings, a modest vehicle, and an annual income of at least \$42,000 per annum. Clearly, the legislative intent is to elevate the well being of people above mere monetary or commercial considerations.

In short, if the debtor's resources are sufficient to discharge all debts, then the civil recovery process is the appropriate procedure, except if the debtor's resources are less than

the minimums defined in the *Bankruptcy Act*. Alternatively, when the debtor's resources are not sufficient to discharge all debts, then the federal insolvency laws provide the appropriate remedies.

## Attributes of an improved system

An improved system will be one that values and exhibits the following traits:

### 1. *Accessibility*

- a. The procedure should be accessible to all who have need of it. Access should not be denied nor the participation prejudiced because of lack of means.
- b. Because most debtors won't be able to afford representation or qualified assistance, the procedures, protocols and language must be kept simple so as to be readily understood by the layman.
- c. It must be possible for people to participate in the process remotely, that is, remote to the forum itself. The use of electronic or correspondence based procedures must be accepted fully to ensure geography is no barrier to participation.

### 2. *Impartiality*

- a. The system must eliminate all bias either perceived or actual.
- b. It must reject the outmoded notion of majority rule for determining outcomes.
- c. It must adopt an objective, problem solving approach entirely divorced from the interests of either debtor or creditor.

### 3. *Inclusive*

- a. The system must ensure that all creditors likely to be affected by the outcome are invited to participate in the process once it is begun.
- b. The system must ensure effective communication with all parties even if they do not actively participate.

### 4. *Speed*

- a. The system must ensure a speedy resolution with the goal of minimising both cost and trauma.
- b. The process should not engage in subjective considerations.
- c. The process should be limited to adjudication on standardised written submissions from both debtor and creditor.

### 5. *Objective*

- a. The goal of the process must be limited to identifying the maximum lawful repayment that can be made by the debtor and how to achieve it.

- b. The adjudicator will evaluate:
  - i. What is the extent of the debtor's lawful capacity to repay;
  - ii. Will the proposal deliver this maximum result; and
  - iii. What enhancements are necessary to ensure the maximum lawful return is delivered.
- c. The debtor's capacity to pay is objectively calculated by their available funds less non-divisible (exempt) property (per the *Bankruptcy Act*).
- d. Subjective questions must be referred to an appropriate authority for determination rather than be the concern of the adjudicator.
- e. Personal representations should not be received.

**6. Directive**

- a. The determination of the adjudicator will direct what steps are to be taken to effect the repayment of debt (or not, as the case may be).
- b. These directions could be in accordance with the proposal submitted by the debtor or could be varied to any extent.
- c. The directions should specify how payment is to be made and prescribe specific actions to be taken.
- d. It will also identify any priorities that exist and detail how and when these are to be paid. It may also include direction as to dealing with property.
- e. In the event no payment is possible, the direction can be to the debtor to file relevant insolvency papers within a specified period of time.

**7. Enforceable**

- a. The determination must be enforceable and binding against both debtor and all creditors whether supportive or not.

**Who has a stake in developing a new system?**

Obviously, debtor and creditors are concerned. Benefits will also flow to those currently involved in handling such matters being the Courts and regulatory authorities such as ITSA. The success of a new system will entail significant reductions in workloads for these institutions.

**How will the system work?**

The process will begin with a debtor lodging a request for adjudication with a registered adjudicator.

Complete documentation will be submitted to the adjudicator. No matter will be accepted for adjudication unless all debts are ascertained or admitted.

Immediately, the adjudicator will cause an initial advice to be sent to all creditors confirming that adjudication has commenced and inviting them to provide evidence of their claim. In addition, the creditors will be permitted to return a list of questions they would like answered by the debtor. This list of questions will provide to the adjudicator who will decide which if any of the questions will assist him or her to arrive at a determination. Those questions will then be posed to the debtor by the adjudicator and the responses considered along with the standard information provided. No more than one schedule of questions per creditor will be accepted.

The adjudicator will make a determination based on the facts before him or her. In making the determination he or she will specify:

- the parties bound by the determination;
- how much is to be repaid;
- the manner or rate or repayment;
- what structures or other arrangements are required to give effect to the determination;
- if repayment is not possible, the alternative actions to taken;
- who will supervise the implementation of the directions given;
- what remuneration the Deed Supervisor (discussed below) will be paid;
- the specifics of any moratorium to apply to creditors; and
- the calculation, timing and manner of dispersal of the dividend among creditors.

## **The Challenge of Enforcement**

The value of the adjudication process is limited to the effectiveness of its enforcement procedures. In my submission this challenge is readily overcome by:

- using only registered adjudicators;
- having the debtor execute his or her proposal in the form of a Deed;
- appointing a Deed Supervisor to supervise the Deed; and
- giving limited power of attorney to the Deed Supervisor to take control of the debtor's property and affairs to the extent necessary to carry the terms of the determination into effect.

The determination of registered adjudicators will be supported by the enforcement powers of the Supreme Court. Any attempt to subvert, marginalise or obviate the terms of the determination can be met with appropriate sanction including but not limited to contempt.

Adopting the Deed to ratify the determination will give rise to enforcement by way of specific performance or damages, while giving the Deed Supervisor a limited power of attorney will ensure fast redress against property in the event of default by the debtor. In the event that real property is dealt with in the determination, the Deed Supervisor will be in a position to register a caveat immediately.

Unfortunately, however, Commonwealth creditors such as the Australian Taxation Office and Centrelink will not be bound. Wherever such creditors exist, it is suggested that the determination include an instruction to the debtor to apply for release from the balance of such liabilities (calculated as the debt less the creditors share of dividend payments) under

federal Relief and Hardship provisions.

### **The involvement of IAMA members**

Members of IAMA are ideally placed to fulfil the role of adjudicator. They are expertly trained and are seen to be an independent and impartial authority. They have standing within the legal system and are represented in most jurisdictions. They are also schooled in fast tracking problem resolution.

They are not experts, however, in financial assessment. Therefore, the role of the adjudicator should be limited to receiving information, clarifying for their understanding and then making the determination.

### **How is the process begun?**

The adjudication process could be begun at any time by the debtor submitting a proposal, statement of supporting information and list of creditors to the adjudicator. Preferably a debtor will initiate the process of adjudication prior to legal proceedings being commenced against them. Adjudication could also be begun post judgment and before execution.

### **Costs of the procedure**

In acknowledging the principle of equal culpability, it seems just and equitable that the cost of the procedure be borne equally by debtor and creditor. While there will be differing opinions on this, my solution is to divide the costs of the process plus the administration of the Deed to finality among the number of parties to the Deed viz. the number of debtors and creditors. Each will pay respectively. The creditors will have the amount deducted from their dividends before final distribution, the debtor will pay directly to the Deed Supervisor who will disperse payment to the Adjudicator before other disbursements are made.

### **Limit on creditor claims**

The claim of a creditor should be limited to the same level of a provable debt assessed in accordance with the provisions of the *Bankruptcy Act* or *Corporations Law* as appropriate. For this purpose, the debtor will be taken to have become bankrupt or to have been wound up on the day the application for adjudication is accepted by the adjudicator.

It would be fair and reasonable, when making a determination for the adjudicator, to order that creditor legal costs incurred after the commencement of the adjudication process be afforded the lowest priority for repayment. This will dissuade creditors acting capriciously and encourage debtors to engage the process early.

## Benefits of an adjudication system

There is much to gain from this new approach. First it will offer an independent determination of a fair outcome by eliminating emotional bias from the resolution process. It will fast track results by addressing the threshold question of capacity to pay first. This will dispose of lengthy disputes over the quantum of indebtedness now fought in Court. It will reduce the need for formal administrations under insolvency laws by providing a binding effective alternative. Because fair and fast resolution is achievable, the level of trauma currently associated with protracted debt collection process will be greatly reduced.

All of these benefits will produce cost savings and improved commercial returns.

## Summation

There is a need to improve the manner in which our society deals with debt issues. The introduction of an impartial assessment and adjudication process to determine and enforce the optimum resolution will:

- provide fair outcomes faster;
- reduce the costs of collection;
- minimise trauma; and
- free up Court and government resources

