Manager
Corporations and Schemes Unit
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The Treasury
Langton Crescent
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Dear Sir / Madam

Submission on Improving bankruptcy and insolvency laws Proposals Paper

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We thank you for the opportunity to comment on the Improving Bankruptcy and Insolvency Laws Proposals Paper. Our comments relate to the first and second proposals, being reducing the current default bankruptcy period from three years to one year and introducing a 'safe harbour' for directors in relation to the insolvent trading provisions.

Reducing the Default Bankruptcy Period

Item 1.2 – Ongoing Obligations for Bankrupts.

1. We agree with Proposal 1.2.2 in relation to the obligation to pay income contributions from the default bankruptcy period, but suggest that a full review of the income contributions scheme occur.

Item 1.3 - Restrictions

2. In relation to Proposal 1.3, we make the following general comments. The stated aim for the proposed reform to decrease the mandatory bankruptcy discharge period was to increase innovation and entrepreneurial activity. However, we would argue that a reduction in the mandatory discharge period is unlikely to achieve these objectives given that the most common causes of bankruptcy are not business related. Therefore, reducing the default period to one year may have little impact on encouraging entrepreneurial behaviour. Furthermore, while we do not, in principle, disagree with reducing the mandatory discharge period to one year (particularly in the context of effectively balance the interests of creditors, debtors and community interests within Australia), we consider that the focus of the reforms should be on obtaining a comprehensive understanding of the causes of bankruptcy and addressing those issues.
3. Insolvency laws invariably must balance the competing interests of creditors, debtors and the general community. Australia's present laws regarding mandatory bankruptcy discharge periods and associated restrictions on debtors during those periods reflects the current balance, which may be considered "creditor protective". The Australian Federal Government's (Government)

Improving Bankruptcy and Insolvency Laws Proposal Paper[1] outlines three substantive reforms, one of which is to reduce the current mandatory discharge period for personal bankruptcy from three years to one year. The underlying purpose of reducing the default bankruptcy period to one year is to "encourage entrepreneurial endeavour and reduce the associated stigma" of being a bankrupt. While it is considered that reducing the default bankruptcy period to one year will improve a debtors' opportunity for a fresh start such a change will not generally encourage entrepreneurial endeavour, nor necessarily reduce the associated stigma of being a bankrupt for the reasons outlined below. Rather, without specific restrictions, the change has the potential to correspondingly harm creditors, increasing costs which may reduce available lines of credit, which ultimately impacts all future borrowers.

4. It is considered that both the personal/emotional and economic/financial stigma of being a "bankrupt" will exist whether the mandatory bankruptcy discharge period is one or three years. Howell and Mason[2] make the argument that there are numerous restrictions within Australian legislation, regulations and professional rules at Commonwealth, State and Territory level which facilitate formal and informal bankruptcy stigmatisation in employment and business. We suggest that reducing the minimum period of bankruptcy would have a particular impact on occupational restrictions that are imposed only while a person is undischarged, but importantly offer alternative reform measures outside of the *Bankruptcy Act 1966* (Cth) which better address the stigmatisation or labelling arising from bankruptcy, regardless of its duration. Such alternatives include:
    4.1. a policy review to determine the justification and legitimacy of imposing barriers to entry to occupations on the grounds of bankruptcy;[3] or
    4.2. amendment of the National Personal Insolvency Index (NPII) so that it no longer operates as a permanent public record of an individual's bankruptcy[4] and restriction of the circumstances in which access to the NPII is granted.[5]
5. While acknowledging that "bankruptcy can be a result of necessary risk-taking or misfortune, rather than misdeed"[6] the Government's proposed reform measure ignores the reality that the majority of personal bankruptcy cases are consistently caused by non- business[7] related reasons. Historically "the overwhelming majority of bankruptcy cases result from consumer debts, that is, debts incurred in the consumption of goods and services as distinct from those incurred in the course of conducting a business."[8] Since 2007-2008 the proportion of debtors entering personal insolvency because of non-business related reasons has only varied between 79% (lowest in

[1] Australian Government, Department of Treasury *Improving bankruptcy and insolvency laws* Proposal Paper, April 2016.
[2] Nicola Howell and Rosalind Mason, "Reinforcing Stigma or Delivering a Fresh Start: Bankruptcy and Future Engagement in the Workforce","[2015] *UNSWLawJl* 58; (2015) 38(4) *University of New South Wales Law Journal* 1529.
[3] Howell and Mason, as above n2, 1570.
[4] Howell and Mason, as above n2, 1572.
[5] Howell and Mason, as above n2, 1573.
[6] Australian Government, Department of Treasury, Proposals Paper, above n 1, 5.
[7] The Australian Financial Security Association [AFSA] categorises bankruptcies as either business related or non-business related. In a 'business bankruptcy' the debtor's insolvency is reported as being directly related to the debtor's proprietary interest in a business.
[8] John Duns, and Rosalind Mason,'Consumer Insolvency in Australia' (2001) 10, 3 *International Insolvency Review* 195.

2012-13) to 88% (highest in 2008- 2009).[9] Latest available figures from AFSA indicate that in 2013-14 81% of debtors entered personal insolvency because of non-business related reasons such as unemployment or loss of income; excessive use of credit; and domestic discord or relationship breakdowns.[10] The Government's proposed one year mandatory discharge period with accompanying restrictions (excluding income contributions) is based upon the Productivity Commission's (Commission) rather tenuous arguments of improving entrepreneurial activity and comparability with similar insolvency law based countries such as United Kingdom, New Zealand and Ireland. Yet the Commission acknowledges that like the UK experience[11] these changes are "unlikely to have a pronounced, immediate effect, but should provide an overall signal to bankrupts and potential lenders that over time, should lead to some shift in culture and encourage re-starts."[12]

6. A key justification for the UK's reduction of its bankruptcy discharge period was 'to encourage entrepreneurship and responsible risk taking'.[13] Entrepreneurial theory considers "the fundamental purpose of discharge is to foster entrepreneurship."[14] Shorter discharge periods are justified by entrepreneurial theory as a means of incentivising debtors to be confident in taking risks to start new business ventures, which is beneficial not only to the debtor but also to the community.[15] The caveat on shortening the discharge period is it may encourage debtors to invest in inefficient ventures.
7. While this may be relevant to the UK position, entrepreneurial theory has little relevance to the shortening of the discharge period in Australia, as "consumer bankrupts are far less likely to engage in entrepreneurial activity than business bankrupts".[16] Australia experiences a very high percentage of consumer debt bankrupts, (81%) as opposed to the UK's percentage of consumer debt bankrupts (35%) in 1998-99 when its discharge period was shortened.[17]
8. Adopting a broad brush approach by granting all bankrupts a reduced discharge period (with the exception of those known to be guilty of misconduct) has its own risks. Doing so may, for

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[9] Australian Financial Security Association [AFSA] *Business and Non-Business Statistics* https://www.afsa.gov.au/resources/statistics/provisional-business-and-non-business-personal-insolvency-statistics

[10] Australian Financial Security Association [AFSA] *Business and Non-Business Statistics* https://www.afsa.gov.au/resources/statistics/provisional-business-and-non-business-personal-insolvency-statistics

[11] The Insolvency Service Report 2007 in the United Kingdom noted that a Bankrupt's ability to recommence trading was still hindered by a bankrupt's restricted access to the financial market. See Australian Government Productivity Commission Inquiry Report, *Business Set-up Transfer & Closure* No 75, 30th September 2015, 337.

[12] Australian Government, Productivity Commission Inquiry Report, *Business Set-up Transfer & Closure* No 75, 30th September 2015 340.

[13] Insolvency Service, Department of Trade and Industry*, United Kingdom, Productivity and Enterprise: Insolvency — A Second Chance, Cm 5234 (2001) [1.1]* in John King, "Moving beyond the 'Hard' – 'Easy' Tug of War: A Historical, Empirical & Theoretical Assessment of Bankruptcy Discharge" [2004] *MelbULawRw* 22, 42.

[14] John King, "Moving beyond the 'Hard' – 'Easy' Tug of War: A Historical, Empirical & Theoretical Assessment of Bankruptcy Discharge" [2004] *MelbULawRw* 22, 42.

[15] King, above n 15, 42.

[16] King, above n 15, 42.

[17] *Insolvency Service, Department of Trade and Industry, United Kingdom, Bankruptcy — A Fresh Start: A Consultation on Possible Reform to the Law Relating to Personal Insolvency in England and Wales (2000) [2.3]* in John King, "Moving beyond the 'Hard' – 'Easy' Tug of War: A Historical, Empirical & Theoretical Assessment of Bankruptcy Discharge" [2004] *MelbULawRw* 22, 42.

[17] John King, "Moving beyond the 'Hard' – 'Easy' Tug of War: A Historical, Empirical & Theoretical Assessment of Bankruptcy Discharge" [2004] *MelbULawRw* 22, 42.

example, inadvertently encourage those discharged consumer debt bankrupts to continue their excessive use of credit, rather than address the need for further calculated risk-taking and entrepreneurial endeavour. One means of achieving a balance of creditor, debtor, and community interests is to **categorise bankrupts** according to characteristics such as level of indebtedness to income, ownership of property and number of bankruptcies. The eligibility of a 12 month default bankruptcy period could be restricted to only those debtors whose primary business-related cause of insolvency is "economic conditions affecting industry", however, this may also be problematic and arbitrary. John King suggests a shortened discharge period should be reserved for 'unfortunate bankrupts' as opposed to fraudulent or reckless bankrupts and those bankrupts able to repay their debts.[18] Relying in part on the repealed early discharge bankruptcy provision, eligibility criteria, such as 150% rule, may be used to identify reckless bankrupts, although King suggests that the Trustee be able to exercise his or her discretion to discharge a bankrupt where fairness and consistency warrant.

9. A further means of addressing the conflicting concerns of debtors, creditors and community is to impose specific **education measures** upon undischarged bankrupts to attend and satisfactorily complete financial literacy classes during their period of bankruptcy. Recalcitrant undischarged bankrupts, may be incentivised to attend such classes, if Trustees were able to lodge an objection to the bankrupt's discharge on the grounds of failure to attend. The Australian Law Reform Commission believed a discharged debtor should 'return to the market with an improved sense of budgeting and of the danger of over-commitment of meagre income' and 'a proper understanding of credit and a sense of his own responsibilities'.[19] An empirical research study conducted of Australia's personal insolvency laws and their practical impact on people in financial distress[20] provides support for the need for financial literacy education of undischarged bankrupts. Several participants within the study's online survey[21] attributed their clients' ongoing financial problems to a lack of financial literacy. One advocate reported that "some clients view bankruptcy as a way of financial management, to be considered more than once."[22] The same advocate further commented that "some clients do continue to experience hardship as they do not change behaviours".[23] Such change may not occur without education as another survey participant acknowledged that creditors' lending practices were also partially to blame, as "some clients go bankrupt more than once … due to the fact that companies allow people to

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[18] King relies to a large extent on the early discharge period previously found in s149T *Bankruptcy Act* 1966 (Cth). Early discharge was only available for those bankrupts who were unable to pay their creditors at all, or who were unable to pay the trustee's remuneration and expenses in full. A bankrupt was ineligible to apply, if he or she satisfied the criteria in s149Y *Bankruptcy Act* 1966 (Cth) such as his/her debts exceeding 150% of his/her income. The *Bankruptcy Legislation Amendment Act* 2002 (Cth) repealed the early discharge provisions based on a number of grounds which King argues were only anecdotal, were misdirected or disputable and contradicted the available evidence. See John King, "Moving beyond the 'Hard' – 'Easy' Tug of War: A Historical, Empirical & Theoretical Assessment of Bankruptcy Discharge" [2004] *MelbULawRw* 22.

[19] Australian Law Reform Commission, *Insolvency: The Regular Payment of Debts*, Report No 6 (1977) [142] in John King, "Moving beyond the 'Hard' – 'Easy' Tug of War: A Historical, Empirical & Theoretical Assessment of Bankruptcy Discharge" [2004] *MelbULawRw* 22, [245].

[20] P. Ali, L. O'Brien, and I. Ramsay, *Perspectives of Financial Counsellors and Consumer Solicitors on Personal Insolvency*, ARC Linkage Grant.

[21] The survey participants included financial counsellors, consumer solicitors and other advocates specialising in helping financially distressed individuals.

[22] Ali et al., above n 26, 10.

[23] Ali et al., above n 26, 10.

apply for credit cards very quickly after … being discharged from bankruptcy."[24] While AFSA promotes on their website the free, independent and confidential services of Financial Counsellors to assist debtors in managing their financial affairs, at present, there is no mandatory requirement for undischarged bankrupts to complete financial literacy classes. Yet without accompanying financial education, the reduction in the default bankruptcy period increases the potential for repeat bankruptcies.[25]

Safe Harbour for Insolvent Trading Provisions

Item 2.2 – Safe Harbour Model A

10. We agree that there should be law reform in relation to restructuring options rather than entering into voluntary administration. However, we do not consider Safe Harbour Model A is a practical solution.
11. In relation to Queries 2.2.1a and 2.2.1b, our view is that restructuring advisors appointed under such a model should maintain the same qualifications and experience, and be subject to the same registration requirements, as that of other insolvency practitioners – particularly given that the restructuring advisor will play a pivotal role in both models in terms of preventing insolvent liquidation and voluntary administration arrangements. This is particularly the case if Safe Harbour Model A is adopted.
12. The law in relation to the educational requirements of insolvency practitioners is still in progress.[26] However, the Insolvency Practice Rules proposals paper (2014) recommended that a registered insolvency practitioner should complete a prescribed level of formal tertiary study that specifically focusses on insolvency administration, including both legal and accounting aspects.[27] It is not clear whether the proposed education requirements will require undergraduate degree qualifications in accounting or law, but we would suggest that the entry requirement for insolvency practitioners, including restructuring advisors, should comprise post-graduate qualifications that include accounting, legal and strategic management aspects relevant to insolvency and restructuring.
13. In relation to Query 2.2.1e, it is our view that the proposed Safe Harbour Model A would be uncertain in its application as it will require the determination of what is reasonable on a case by case basis. Furthermore, as per Queries 2.2.1c and 2.2.1d, while there are several methods in which a company's viability may be measured, the usefulness of one method over another will largely depend on the particular characteristics of the company involved. Therefore, it is unlikely that a standard measure of viability could be introduced into the framework.
14. For these reasons, our preferred model is **Safe Harbour Model B.**

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[24] Ali et al., above n 26, 10.
[25]Repeat bankruptcies can arise as the *Bankruptcy Act* does not expressly limit serial bankruptcy filings with the exception of s55 *Bankruptcy Act 1966* (Cth).
[26] See generally the Insolvency Law Reform Act 2016, yet to commence. The professional education requirements are to be detailed in the Insolvency Practice Rules. A proposals paper was introduced in 2014 but has not, as yet, progressed further.
[27] See Insolvency Practice Rules Proposal Paper, November 2014, para [21], at http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2014/ILRB-2014.