Our Ref: MEL
Your Ref:

PiperAlderman

24 May 2016

By Email: insolvency@treasury.gov.au
Original forwarded by Post

Corporations and Schemes Unit
Financial Systems Divisions
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir

***Improving Bankruptcy and Insolvency laws* – Response to Proposals paper dated April 2016**

I make this submission in response to the request for feedback contained within the Proposals Paper dated April 2016 titled "Improving Bankruptcy and Insolvency Laws" (**Proposals Paper**). I particularly wish to address the proposed amendments to the *Bankruptcy Act 1966* (**Act**).

By way of background I am a partner of the national law firm Piper Alderman. I have practiced for over 24 years in insolvency and reconstruction law having particular expertise and experience in bankruptcy law. I am the immediate past national chair of the Law Council of Australia's Insolvency and Reconstruction Committee, a member of the ARITA Victorian/Tasmanian State Committee and a former representative of the Law Council of Australia on the Bankruptcy Reform Consultative Forum. I have given evidence to a number of Commonwealth Parliamentary inquiries in relation to Bankruptcy reform including in relation to the *Bankruptcy Legislation Amendment Bill 2002* that resulted in the repeal of the "early discharge" provisions within the Act.

Lawyers

Melbourne Sydney
Brisbane Adelaide

ABN 42 843 327 183

Level 24
385 Bourke Street
Melbourne Vic 3000
Australia

All correspondence to:
GPO Box 2105
Melbourne Vic 3001
Australia

DX 30829 Collins Street Melbourne

t +61 3 8665 5555
f +61 3 8665 5500

www.piperalderman.com.au

Partner:
Michael Lhuede
t +61 3 8665 5506
mlhuede@piperalderman.com.au

Executive Summary

1. The underlying premise of the Proposals Paper, that the reduction of the period of bankruptcy to one year will encourage entrepreneurship, is illusory and is not supported by the facts.

2. However the reduction of the standard period of bankruptcy from three years to one year may well be a means to eliminate perceived failings in bankruptcy administration that undermine public confidence in the existing regime.

3. Any reduction of the standard period of bankruptcy should be in conjunction with a more robust regime of objecting to discharge from bankruptcy for those bankrupts whose conduct warrants or requires an extension of the bankruptcy beyond one year.

4. The residual provisions of the Act should remain substantively unchanged.

Challenging the underlying premise of the Proposals

While I address in turn below the specific matters raised within the Proposals Paper, at the outset I wish to challenge the fundamental premise behind the proposal for reform of the Act. In particular I challenge the basis of the suggestion that the reduction of the standard period of bankruptcy from three years to one "will strike a better balance between encouraging entrepreneurship and protecting creditors".

The objectives of the *Bankruptcy Amendment Act 1991*[1], which introduced the current objection regime and the concept of "early discharge", were described within the Explanatory Memorandum[2] as follows;

> *Bankruptcy has traditionally had two principal aims, the first being the return of funds to creditors and second the rehabilitation of the bankrupt. …….. Similarly, access to early discharge from bankruptcy has been denied to many bankrupts because of the costs associated with obtaining an early discharge. The 2 main purposes of the Bill are to establish a more efficient and effective means of securing contributions from the income of a bankrupt and to enhance the opportunities of persons with levels of debt that they have no prospect of repaying to begin the process of financial rehabilitation at an early date.*[3]

Yet only 10 years later, on 21 March 2002 the then Attorney-General, the Honourable Daryl Williams AM QC MP, issued a press release stating:

[1] Sometimes referred to in the media as the "High Flyer Amendments", I well remember as a junior lawyer the commencement of this Act which was so called for those "luminaries" of the entrepreneurial world that graced the corporate failures of the late 1980's such as Christopher Skase and Alan Bond.

[2] *Explanatory Memorandum to Bankruptcy Legislation Amendment Bill 1991* @ para 2

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> *Bankruptcy should be a last resort for people who have overwhelming debts and need a fresh start. However, some people see it as a way to get out of paying debts they can afford to pay.*
>
> *The new Bankruptcy laws will make it harder for these people to abuse Australia's bankruptcy system.*
>
> *Changes under the Bankruptcy Legislation Amendment Bill 2002 include:*

- *A new discretion for Official Receivers to reject a debtor's petition where it appears that the debtor can afford to pay their debts and petition is an abuse of the bankruptcy system;*
- *The removal of early discharge provisions that have permitted some* people to be bankrupts for only six months;
- *The strengthening of trustee powers to object to the discharge from bankruptcy of uncooperative bankrupts after the standard three year bankruptcy period;* [4]

This response had been flagged almost two years earlier by the then Minister for Justice and Customs, the Honourable Senator Vanstone. In a paper[5] delivered to the Australian Institute of Credit Management National Conference on 11 May 2000 the Minister stated:

> *The plain fact is that Community confidence in the bankruptcy system has eroded.*
>
> *The concern used to be that big business flouted bankruptcy laws. The concern now is that small consumer debtors do not take bankruptcy seriously. This is fuelled by rising numbers of bankrupts. Bankruptcies have increased threefold over the last ten years. Bankruptcies have increased threefold over the past five years, to a level of 26,376 in 1998-99. Most of the growth is in "consumer bankruptcies".*
>
> *The rising numbers are due to the following factors; excessive borrowing prompted by ready credit availability, perceptions of*

[4] Copy Press Release attached
[5] Copy attached

attainable living standards, and a lessening of the stigma attached to bankruptcy.

We cannot ignore the fact that community confidence in the bankruptcy system has eroded. That confidence must be restored.

The government has developed a package of reforms to restore confidence in the bankruptcy system.

We want to:

- *Make it clear to debtors that bankruptcy is a serious choice.*
- *Ensure that bankrupts who misbehave or don't cooperate are dealt with, and importantly,*
- *Allow people who are insolvent to quickly make a fresh start.*

The Explanatory Memorandum to the *Bankruptcy Legislation Amendment Bill 2002* stated:

The Bankruptcy Legislation Amendment Bill 2002 (the Bill) will make a number of significant changes to bankruptcy law. The changes address concerns that the bankruptcy system is biased toward the debtor and that debtors are not encouraged to think seriously about the decision to declare themselves bankrupt. The changes also address unfairness and anomalies, particularly in relation to the operation of the early discharge arrangements and the lack of effective sanctions on uncooperative bankrupts.

If, by the aforementioned amendments, debtors have been encouraged to "*think seriously about the decision to declare themselves bankrupt*" then we should hesitate before introducing changes designed to effect the engineering of societal attitudes. My concern is that the Proposals Paper advances a proposition that may well favour a regime designed to promote entrepreneurship over individual responsibility for financial decisions.

The impact of the proposal for a one year bankruptcy, and its stated design to encourage entrepreneurship, must also be considered in light of the potential impact such changes might have upon the operation of other regimes within the Act. Since 2002 we have seen the development of Part IX Debt Agreements as a viable alternative to bankruptcy for a large body of consumer debtors. The take up of Part IX might well be seen as a reflection of community

attitudes to the stigma and effects of bankruptcy. If that attitude is to be discouraged in favour of being accepting of financial failure then we may well be altering the very assumptions on which debtors to date have been willing to reach agreement under Part IX with their creditors. Any changes to the Act should be careful to avoid any distortions that would discourage debtors from reaching commercial arrangements with creditors under Part IX of the Act.

AFSA have historically published biennially, a profile of debtors taking advantage of one of the administrations under the Act. The last profile published was in relation to the 2011 year[6]. This document usefully maps the profile of the average debtor and the changes in the use of bankruptcy which have taken place within Australian society since 2003.

It states:

> *Since 2003, the following patterns in the socio economic characteristics of bankrupts are noted:*
>
> *Demographics*
>
> *Males consistently comprise more than half of all bankrupts.*
>
> *The age of bankrupts has consistently increased since 2003, with the proportion of bankrupts aged 18 to 39 declining and those aged 40 and over increasing.*
>
> *Single people without dependants are consistently the most represented family situation in bankruptcies.*
>
> *The proportion of bankrupts who are members of couples with dependants has increased and the proportion of single bankrupts with dependants has fallen since 2003.*
>
> *Primary causes of bankruptcy*
>
> *' Unemployment or loss of income' has consistently been nominated as the most frequent primary cause of insolvency for non-business related bankruptcies since 2003.*
>
> *' Economic conditions affecting industry' have consistently been nominated as the most frequent primary cause of insolvency for business-related bankruptcies2 since 2003. In 2009, an*

[6] See Profile of Debtors 2011 (Commonwealth of Australia 2012)

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unprecedented proportion of bankrupts nominated 'economic conditions affecting industry' as the primary cause of business-related bankruptcies. This declined in 2011 but remains high relative to previous years.

There has been a consistent decline in the proportion of bankrupts attributing the primary cause of business-related bankruptcies as 'lack of business ability'.

The proportion of male bankrupts who were not employed at the time of bankruptcy has fallen 11% and the proportion of female bankrupts who were not employed at the time of bankruptcy has fallen 15% since 2003.

Income and debt

The proportion of bankrupts who earned $0 to $29 999 has consistently fallen and the proportion of bankrupts who earned $30 000 or more has increased since 2003. However, the majority of bankrupts continue to earn less than $30 000.

The majority of bankrupts have debts of $20 000 or more. The proportion of bankrupts with debts below $20 000 has steadily declined since 2003. The proportion of bankrupts with unsecured debts of $100 000 or more has increased from 11% in 2003 to 27% in 2011.

The proportion of unsecured debt to finance institutions owed on credit cards and personal loans has declined since 2003.

This demographic should be mapped against the numbers of bankruptcies occurring in Australia and the causes of those bankruptcies. In particular AFSA draws a distinction between business and non business bankruptcies – business bankruptcies arising from a business failure of the debtor.

The AFSA website [7]contains an analysis of causes of bankruptcy in the 2012-2013 and 2013-2014 years. It includes the following which are extracted directly from the website:-

Causes of business related personal insolvencies

[7]www.afsa.gov.au

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Main reason for entering a business related personal insolvency	***Number of insolvent debtors in 2012-13***	***Number of insolvent debtors in 2013-14***
Economic conditions	*2680*	*2378*
Excessive drawings	*338*	*395*
Excessive interest	*287*	*227*
Failure to keep proper books	*150*	*158*
Gambling or speculation	*41*	*35*
Inability to collect debts	*137*	*125*
Lack of business ability	*272*	*245*
Lack of capital	*353*	*398*
Personal reasons including ill health	*492*	*446*
Seasonal conditions	*132*	*103*
Other business reason	*1862*	*1347*
Total	***6744***	***5857***

(a) Most personal insolvencies are not business related

In 2013-14, 19% of debtors entered a personal insolvency because of business related reasons.

Since 2007–08, the proportion of debtors entering a personal insolvency because of business related reasons reached a:

- *peak in 2012–13 (21% of debtors)*
- *low in 2008–09 (12% of debtors).*

Causes of non-business related personal insolvencies

Main reason for entering a non-business related personal insolvency	***Number of insolvent debtors in 2012-13***	***Number of insolvent debtors in 2013-14***
Unemployment or loss of income	*8333*	*8418*
Excessive use of credit	*7649*	*6999*
Domestic discord or relationship breakdown	*3063*	*3056*
Ill health	*2235*	*2160*

Adverse legal action	*659*	*682*
Gambling or speculation	*541*	*544*
Liabilities due to guarantees	*359*	*446*
Not stated	*354*	*506*
Other non-business reason	*1851*	*1627*
Total	***25044***	***24438***

(b) Most personal insolvencies are not business related

In 2013–14, 81% of debtors entered a personal insolvency because of non-business related reasons or the reason was unknown.

Since 2007–08, the proportion of debtors entering a personal insolvency because of non-business related reasons reached a:

- *peak in 2008–09 (88% of debtors)*
- *low in 2012–13 (79% of debtors).*

In addition to the above statistics it is to be noted that Part IX of the Act today sees a significant number of debtors seeking protection under that regime resulting in material returns to creditors.

The provisional 2014-2015 bankruptcy statistics published by AFSA are as follows:-

Provisional annual personal insolvency statistics 2014-15

State / territory	Bankruptcies (Parts IV and XI)	Debt agreements (Part IX)	Personal insolvency agreements (Part X)	Total personal insolvency activity
Total	**17,163**	**10,911**	**214**	**28,288**

Looking at this large volume of non business bankruptcies as a proportion of total bankruptcies and the demographic of the average bankrupt there must be material doubt as to the assumption underpinning the Proposals Paper namely, that it will encourage entrepreneurship. The available data, as noted above, does not support the conclusion that there is missed or supressed entrepreneurial opportunity within the current bankruptcy demographic. In my experience, dealing with bankrupts across the complete range of socio-economic backgrounds, the spark of entrepreneurship the Proposals Paper seeks to fan either does not exist or alternatively is so rare as not to warrant the risks of such fundamental change.

Whether society at large still holds the concerns expressed by Senator Vanstone in 2000 and the Attorney-General in 2002 is moot. In my professional experience bankruptcy continues from time to time to be seen as too lenient and open to abuse. While the intention of reducing the stigma associated with business failure may be a noble objective it is not necessarily in line with community attitudes that bankruptcy and failure to repay financial indebtedness should have real and material consequences. That said, I have been unable to identify any economic benefit in the retention of a three year bankruptcy period for the vast majority of consumer bankrupts.

An alternative rationale for a One Year bankruptcy term

Notwithstanding that I do not accept the premise of the proposed amendments I still maintain there is a good and valid reason as to why, subject to the existence of a robust mechanism to extend bankruptcy in appropriate cases, the period of bankruptcy should be reduced to one year.

There is a widely held industry view, supported by a large body of anecdotal evidence, that the Official Trustee in Bankruptcy systemically fails to administer bankruptcy administrations[8] in accordance with its obligations and duties under the Act. Time and again I hear within the profession complaints of failures and inefficiencies within the office of the Official Trustee[9]. This creates a split system where Registered Trustees are subjected to the stringent requirements of the Act in the administration of estates, which standards are not necessarily applied equally to those administrations conducted by the Official Trustee[10]. It also gives rise to the very real risk of debtors "forum shopping" for a perceived more favourable or lenient trustee.

Having regard to the sheer number of bankruptcy administrations, most of which are "consumer bankruptcies" in which there will never be a realisation or return to creditors, the Official Trustee is not resourced to conduct its administrations with the same diligence required of Registered Trustees. This is an economic reality and in making this observation I do not seek to criticise the office of the Official Trustee and AFSA which is faced with the unenviable task of having to allocate limited public resources within the statutory framework of the Act.

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[8] AFSA statistics published on its website state that in the 2014-2015 year the Official Trustee administered 81% of all bankruptcies.

[9] These observations are rarely publicised by Registered Trustees who are regulated by the same body of which such complaints are made.

[10] The role of the Official Trustee and registered trustees in administering estates under the Act is the same. Both are fiduciary roles and subject to the same fiduciary standards and duties – see generally *Adsett v Berlouis* (1997) 32 FCR 201

It has long been a matter of debate[11] as to how to equitably deal with these consumer bankruptcies while not creating a split system whereby business bankruptcies are treated differently.

The introduction of a standard one year bankruptcy, subject to any objection extending it, would go a considerable way to addressing these concerns in that the financial impost of administering estates for no commercial or social policy reason would be limited in the vast majority of cases to just one year. That such policy would also permit those bankrupts suffering the misfortune of business failure to resolve their bankruptcies sooner is an incidental benefit.

A Level Playing Field – Reducing Costs and Maximising returns to Creditors?

It is of note that the recent report of the Productivity Commission on *Business Set up, Transfer and Closure* has suggested that small corporate liquidations be administered under a tendered regime at a fixed price. I query whether such similar regime could be introduced into bankruptcy, reducing the role of AFSA primarily to its regulatory function, so as to eliminate any perception around the Official Trustee not administering estates in accordance with its duties. While the costs of any privatisation of the Official Trustee function and the consequential savings to Government will need to be measured I understand through my industry discussions that there will be organisations, utilising modern technology, capable of administering a large volume of consumer bankruptcies in accordance with the obligations and duties under the Act that can deliver more efficient economic and administrative outcomes to all stake holders.

A Robust Objection Regime

The case law has made it clear that the objection regime is not intended to punish a bankrupt but is designed to encourage and enforce compliance with a bankrupt's obligations and duties[12]. To the extent a bankrupt is to be punished for culpable conduct then the offence regime is intended to address such conduct.

I am regularly addressing the frustrations of registered trustees who lament that the existing regime is overly technical and that it permits bankrupts to "thumb their noses" at their obligations and when ultimately called to account can force removal of an objection through then meeting such obligations as required after the fact. This leads to material delay and cost in the administration of bankruptcies.

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[11] I am familiar with this issue through my term on the Bankruptcy Reform Consultative Forum.
[12] See generally *Inspector-General v Nelson* (1998) 86 FCR 67

By way of typical example (with which I am directly familiar) a trustee may be frustrated in the conduct of investigations thorough obfuscation, delay and/or outright failure to comply with requests for information and explanations as to past conduct. The trustee, to encourage performance of the bankrupt's obligations lodges an objection to discharge. All too frequently nothing happens thereafter until the expiration of three years is approaching when the bankrupt may then comply. Having complied the Trustee is required to remove the objection because objections are not to punish but to procure performance. Often this will follow review of the decision to extend the bankruptcy. Now discharged, there is no incentive for the bankrupt to co-operate at all. Of greater significance however the bankrupt has been able to flagrantly breach his or her duties and obligations without material consequence. These actions add materially to the costs of administration which are borne in the first instance by the trustee subject to there being assets available from which to meet remuneration and costs. Such conduct may also undermine public confidence in our bankruptcy laws. These costs create a material obstacle/disincentive for Trustees in determining how far to pursue lines of inquiry. To suggest that these practical realities are unknown in the market place by those advising bankrupts would be naïve.

If there is to be a reduction of the standard period of bankruptcy to one year then there needs to be a more robust objection regime whereby bankrupts are not incentivised to obfuscate and delay fulfilment of their obligations. At present the regime encourages performance after the fact. It is a mere carrot to encourage performance when what is often required is the real threat of stick should obligations be ignored. To the extent that objections are therefore to be a punishment for obdurate failure to perform obligations then that should be expressly permissible.

One process as to how the Act might reflect such a regime would be to place confidence in the regulatory framework and the experience and professionalism of trustees and grant them the discretion to object to discharge on grounds of repeated failures to comply with obligations. Such objections should be reviewable by the Court and not the Inspector-General or AAT. The costs consequences of review are such that trustee's will be dissuaded from frivolous objections. Equally trustees will be under the already existing duty to review any decision to maintain an objection. Further, the Inspector-General always has capability to review a trustee's conduct.

The threat of a bankrupt having to convince a Court that there is a proper basis for him or her ignoring their duties and obligations is one which will likely encourage a more responsive attitude to such duties.

Another ground of objection that might be considered is the existence of an ongoing investigation or action for which the Trustee considers that there will be benefit in keeping the individual subject to the bankruptcy restrictions for a period not exceeding three years or the expiration of such investigations, whichever is the earlier. For example, procuring co-operation of the bankrupt (or even related third parties of the bankrupt) in a public examination or information gathering exercise will often be more readily forthcoming through having the bankruptcy extended.

Other Considerations

1. If there is to be a reduction of the period of bankruptcy to one year, whether to encourage entrepreneurialism or some other objective, that does not of itself constitute a warrant to otherwise reduce a bankrupt's existing obligations, particularly the ability to contribute to a bankrupt estate from income for three years. To remove this latter obligation may well prove a material disincentive to debtors wishing to enter a Part IX Debt Agreement.

   However it should be recognised that it is likely to be more difficult for trustees to extract relevant information and co-operation from a discharged bankrupt in relation to conducting relevant assessments.

2. In relation to the issue of disqualification of directors from managing a corporation an alternative scenario might be to permit the lodging of an administrative "objection" to the discharged bankrupt from managing a corporation by the trustee in an appropriate case.

3. With respect to overseas travel I see no benefit in restricting overseas travel by a bankrupt once discharged. If there is a proper basis to extend the bankruptcy then that should be utilised with the relevant consequences.

4. With respect to the proposal to reduce the retention period for personal insolvency information in credit reports it is important that there is consistency across all regimes under the Act including Part IX debt agreements. Any material reduction of the relevant time period may result in material increase in the searching of the NPII by credit providers which will be an additional cost impost on credit providers.

Should you wish to discuss any aspect of this submission please do not hesitate to contact me.

PiperAlderman

Yours faithfully

Michael Lhuede
Partner