Submission to The Treasury Proposals Paper:
IMPROVING BANKRUPTCY AND INSOLVENCY LAWS

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Response to issues raised on Personal and Corporate Insolvency Regimes

The Treasury has released a Proposals Paper on Improving Bankruptcy and Insolvency Laws for public consultation and input. It addresses 3 issues:

1. Issues to be considered in reducing the default bankruptcy period from three years to one year;
2. Safe harbour for Directors from the insolvency provisions of the Corporations Act; and
3. Constraining the operation of ipso facto clauses, which allow contracts to be terminated solely due to an insolvency event, if a company is undertaking a restructure.

We provide views on each of these areas. Nevertheless, we continue to make the submission to national policy inquiries and discussions that a comprehensive review should be undertaken of the regulation of insolvency and restructuring in Australia. The last comprehensive review of the insolvency system was by the Australian Law Reform Commission (the Harmer Report) and was handed down in 1988. Whilst there have been aspects of our insolvency laws that have been reviewed since that time, none has been able to provide the clear and comprehensive analysis that is able to come from a more considered review. Such a review ought to be conducted by the Australian Law Reform Commission or similar independent panel set up for the task.

We also suggest that there is a lack of data available to assist with addressing questions raised in the Proposals Paper. There is a need to invest in finding out, in a rigorous and informed way, how the current law operates. Until there is a willingness to make a public investment in such research with less reliance upon the anecdotal (often from well-meaning but ultimately inadequately informed participants and others) the government cannot be sure that the insolvency regime we have provides the most effective regime to underpin Australia's commercial and financial dealings.

We also make the submission that there are benefits in a serious investigation into a merged regulatory architecture of personal and corporate insolvency and a combined personal and corporate insolvency regulator.

Reducing the default bankruptcy period

Reducing the minimum length of bankruptcy: Encouraging entrepreneurship

As part of its Innovation Agenda, the Government has announced that it intends to reduce the default period of bankruptcy from three years to one year. This is consistent with Recommendation 12.1 of the Productivity Commission's *Business Set-up, Transfer and Closure* report (September 2015). As with

the Government's Innovation Agenda, the Productivity Commission's report focused on business-related issues, and argued that:

> An extended period of bankruptcy may have negative economic consequences. For instance, potential business owners may be deterred by the fact that individuals are forced to endure a lengthy 'exclusion period' before recommencing business activity following bankruptcy.[1]

And

> Bankruptcy legislation that does not excessively penalise business failure can improve productivity by ensuring that valuable resources are not trapped in inefficient firms (OECD 2015c).[2]

As noted in our submission to the Productivity Commission, we support the reduction of the default bankruptcy period to one year, and agree that such a reduction has the potential to impact positively on business start-ups and entrepreneurial activity.

At the same time, continued attention needs to be paid to the issue of phoenixing and the use of insolvency regimes to allow directors and businesses to discharge debts and obligations through insolvency procedures, and then create a new business with a similar offering. In our submission to the Productivity Commission, we noted that there is an extensive range of corporate law, tax law, criminal law, employment law and fiduciary obligations that addresses the underlying illegality of phoenix activity.[3] We believe that this law is capable of capturing most of the illegal behaviour underlying phoenix activity, despite the many forms in which that behaviour many manifest. Law reform targeting the behaviour underlying phoenix activity is therefore unnecessary given the sheer extent of the existing law. However, timely detection and enforcement of the law would communicate a powerful message essential for both effective deterrence of illegal activity and the promotion of

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[1] Productivity Commission, *Business Set-up, Transfer and Closure* (Final Report, September 2015), 335.
[2] Ibid 336.
[3] See for example under the *Corporations Act 2001* (Cth): the power to wind up solvent companies: s461(1)(k); *Deputy Commissioner of Taxation v Casualife Furniture International Pty Ltd* (2004) 9 VR 549; winding up under s 447A; Uncommercial transactions under, s 588FB(1); See also ss 588FE and 588FC; directors have an obligation to avoid insolvent trading: s588G; fiduciary obligations require the directors to act honestly, in good faith and in the best interests of the company, avoid conflicts of interest and to exercise due care and diligence; directors and other officers of the company must comply with the statutory obligations in ss 180-183 to act with due care and diligence, in good faith and duties not to misuse their position or information so as to cause detriment to the company, to gain personal advantage or an advantage for another. Persons involved in a contravention of s180(2), 181(2), 182(2), 183(2) or 588G(2) are also in contravention of the provision. 'Involved' is broadly defined in s79 and can capture advisors such as those providing legal, financial or restructuring advice to the company; See *ASIC v Somerville* (2009) 259 ALR 574; *Dalmain Holdings Pty Ltd v Rechichi* [2010] WASC 376; directors and other officers commit an offence under s 184 if they are reckless or intentionally dishonest and fail to exercise their powers and perform their duties in good faith and in the best interests of the corporation and for a proper purpose; misuse of position or information can amount to an offence under s 184; ASIC's relevant administrative powers under the *Corporations Act 2001* (Cth), include power to wind up abandoned companies under s489EA, and power to disqualify a person from managing a corporation for up to five years where the person has been an officer of two or more insolvent corporations wound up in the previous seven years: s206F. See also Anne Matthew (2015) 'The conundrum of phoenix activity: Is further reform necessary?'23 *Insolvency Law Journal* 116.

economic confidence in the continued support for legal business failure. If there is to be any further reform, it ought to be directed at relieving the detection and enforcement burden borne by regulators such as ASIC. If the law is to have an effective deterrent effect, then regulators must be well placed to promptly detect transgressions and prosecute offenders.

In this context, we reiterate our submission for a proposal to introduce a Director Identity Number. This will assist regulators in tracking director involvement in the management of multiple companies. Accordingly, ASIC will be better placed to exercise its extensive powers of investigation and enforcement.

We also support the continued availability of an extended period of bankruptcy in cases of fraud or other misconduct, and the continued availability of an offence regime in the bankruptcy system in order to provide deterrence for fraudulent and similar conduct.

Reducing the minimum length of bankruptcy: Facilitating a fresh start for consumer debtors

Although the focus of the Government's policy is on entrepreneurial activity, we note that the vast majority of bankruptcies (over 75% in 2013-2014[4]) are not related to business debts; and that, for many people who enter bankruptcy, existing or potential business / entrepreneurial activity is unlikely to be a significant focus.

However, as with business bankruptcies, there are also sound policy reasons for reducing the minimum bankruptcy period for non-business bankruptcies. These relate to the fresh start objective that is an integral part of the Australian bankruptcy system.[5] An overly long period of bankruptcy clearly inhibits the timing and achievement of this fresh start, particularly when the restrictions associated with bankruptcy are considered.

As we noted in our submission to the Productivity Commission's *Business Set-Up Inquiry*, Australia had previously implemented a shortened discharge scheme, but one that was based on application, rather than automatically applied. This scheme aimed to 'enhance the ability of low income debtors with small debts to begin financial rehabilitation earlier', and John King has argued that the scheme was successful in achieving this objective. [6]

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[4] Calculated from AFSA Datasets: Business causes time series; Non business causes time series. Available at https://www.afsa.gov.au/resources/statistics/socio-economic-statistics/causes-1/causes-of-personal-insolvency

[5] See generally, Nicola Howell, 'The Fresh Start Goal of the *Bankruptcy Act*: Giving a Temporary Reprieve or Facilitating Debtor Rehabilitation' (2014) 14(3) *QUT Law Review* 29.

[6] John King, 'Moving beyond the 'hard'-'easy' tug of war: a historical, empirical and theoretical assessment of bankruptcy discharge' (2004) 28(3) *Melbourne University Law Review* 654, 674.

The early discharge scheme was repealed in 2003, as part of a series of amendments to the *Bankruptcy Act* designed to address concerns that bankruptcy was 'too easy' and that debtors were not using bankruptcy as a last resort.[7] However, King has suggested that

> The abolition of early discharge was debated in an ad hoc manner, with an overriding focus on anecdotal evidence suggesting abuse and the possible discriminatory operation of particular criteria. There was no consideration of the purpose or optimal length of the discharge period.[8]

Some criticisms of the early discharge scheme related to the way in which the scheme was implemented, including the particular criteria used to permit entry into the scheme – they were not criticisms of an early discharge scheme in principle.[9] An appropriate response to these concerns would have been to *improve* the implementation of the early discharge scheme, rather than to prevent its availability at all.

Thus, the proposal to make the shortened discharge period the default, rather than one that is available in limited circumstances, and only on application, addresses many of the concerns that were raised with the structure of the original early discharge scheme.

The more general criticism laid against the early discharge scheme was that it made bankruptcy 'too easy', and encouraged debtors to consider bankruptcy as a first resort, rather than a last resort, considering bankruptcy only after making efforts to repay creditors or otherwise address their financial problems. This perception may be driven, in part, by the occasional high profile cases of apparently wealthy debtors misusing the bankruptcy system. However, evidence that such cases are representative of the bulk of either non business or business bankruptcies is difficult to find.

Efforts to understand the extent of misuse of bankruptcy by debtors who can afford to repay are hampered by the lack of detailed research on bankruptcy in Australia; an issue on which we have commented above. Although this may be starting to change,[10] there is no little or no contemporary research on the experience of debtors, before or after bankruptcy, and this makes it difficult to draw any firm conclusions. However, the limited evidence that is available does not point to any major concerns about abuse or misuse of the bankruptcy system in Australia.

First, most bankruptcies in Australia are reported to have been caused by caused by exogenous and potentially unpredictable factors or changes in circumstances, rather than deliberate attempts to

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[7] Ibid 670.
[8] Ibid 675.
[9] For example, see discussion in King, ibid 668-9.
[10] See, for example, an Australian Research Council Grant 'Evaluating Australia's Personal Insolvency Laws in the Context of Changing Demographics and Increasing Financial Stress' awarded to staff at Melbourne University's Centre for Corporate Law and Securities Regulation, http://law.unimelb.edu.au/centres/cclsr/research/research-grants.

incur debts without intending to repay.[11] This is the case for both business and non-business bankruptcies, as the table below demonstrates:

	Most common causes of bankruptcy in 2013-14 (excluding the catch-all 'Other reason')
Non business bankruptcy	1. Unemployment or loss of income 2. Excessive use of credit facilities 3. Domestic discord or relationship breakdown 4. Ill health or absence of health insurance
Business bankruptcy	1. Economic conditions affecting industry 2. Personal reasons, including ill health and domestic discord 3. Excessive drawings 4. Lack of business ability

This is consistent with the reasons given for bankruptcy and other personal insolvency administrations in many other jurisdictions.[12]

This is also consistent with the now dated, empirical study of consumer bankruptcies in Australia. In his qualitative research with 76 bankrupts in 1987 and 1988, Martin Ryan concluded that:

> … the present research study largely supported the findings of previous research: that most defaulters are victims of changed circumstances rather than being guilty of fraud, recklessness, or a deliberate desire on their part to borrow from the creditor without any intention of repaying their debt.[13]

AFSA statistics are also consistent with there being low levels of abuse and misconduct in the bankruptcy system. The *Bankruptcy Act* provides for trustees to object to automatic discharge on grounds associated with conduct before bankruptcy, including where the bankrupt has made certain transfers before bankruptcy, or spent money or disposed of property without adequate explanation to the trustee or failing to disclose a liability or property interest to the trustee. If there was regular abuse of the bankruptcy system, it might be expected that objections to discharge would be common, however, in 2014-15, there were a total of 20 objections filed (extending bankruptcy to 5 years), and 682 objections filed extending bankruptcy to 8 years.[14] It is not known how many bankruptcies were being administered during the same period, however, the total number of objections in 2014-15

[11] It is noted that these explanations are self-reported, and there may be an issue about reliability: King, above n 6, 672.
[12] See for example, Iain Ramsay (2012) 'Beyond Liberalism and the Social Market: Approaches to Debt Adjustment and Insolvency in the EU' 35(4) *Journal of Consumer Policy* 421, 425, discussing the causes of bankruptcy and over indebtedness in the UK, France and Germany.
[13] Martin Ryan (1995) *The Last Resort: A Study of Consumer Bankrupts* (Avebury), 210.
[14] AFSA Dataset, *Objections to Discharge* at www.afsa.gov.au/resources/statistics/annual-administration-statistics.

amounts to around 1% of the combined total of new bankruptcies in the three year period July 2012 – June 2015.[15] Further, some of these objections are likely to relate to conduct occurring during bankruptcy. In addition, there were only a small number of bankruptcy offence referrals accepted (696) or offences proven (105) in 2014-15,[16] again suggesting that there is minimal abuse of the bankruptcy system.

It might also be expected that if there were significant numbers of debtors using bankruptcy when they were in a position to repay debts, there would be large numbers of bankrupts reporting high incomes, and a high value of assets, on bankruptcy, but this is not the case.[17] AFSA's 2011 *Profile of Debtors* shows that nearly half of debtors (43%) were not employed at the time of bankruptcy,[18] and more than three-quarters (78%) had incomes below $50,000 at the time of bankruptcy.[19] In relation to assets, 64% of bankrupts had no realisable assets, and only 13% had realisable assets of $20,000 or more.[20]

Another rationale for reducing the default bankruptcy period is to minimise administration costs. As noted above, most bankruptcies involve people with low incomes and few, if any, realisable assets. In most of these cases, a bankruptcy period of three years is likely to achieve little additional return to creditors than would a shorter bankruptcy period, but will incur additional administration costs. In fact, one of the reasons given for the introduction of the previous early discharge scheme was to reduce costs.[21]

A reduction in the default period of bankruptcy from three years to one year is also consistent with approaches taken in comparable jurisdictions, including the USA, Canada, the UK and others.[22] Ireland is an interesting example here too. Despite historically having a particularly harsh bankruptcy regime,[23] it has very recently and rapidly decreased its bankruptcy period from 12 years to 3 years in 2013, and from 3 years to 1 year in 2016.[24]

New Zealand retains a minimum three-year bankruptcy period; however, there is the option of applying for early discharge. New Zealand also has available the option of a No Asset Procedure for

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[15] The total new bankruptcies in the period July 2012 – June 2015 was 56,624. Calculated from AFSA Dataset *New bankruptcies trustees*, available at https://www.afsa.gov.au/resources/statistics/annual-administration-statistics.

[16] AFSA *Annual Report 2014-15*, 17.

[17] See also the discussion in King about the lack of evidence of abuse at the start of the 20th century: King, above n 6, 671-3.

[18] AFSA, *Profile of Debtors 2011*, 17.

[19] Ibid 18.

[20] Ibid 25.

[21] King, above n 6, 680-81.

[22] Nicola Howell and Rosalind Mason (2015) 'Reinforcing stigma or delivering a fresh start: Bankruptcy and future engagement in the workforce' 38(4) *University of New South Wales Law Journal* 1529, 1572-8.

[23] See Joseph Spooner (2012) 'Long Overdue: What the Belated Reform of Irish Personal Insolvency Law Tells Us About Comparative Consumer Bankruptcy' 86 *American Bankruptcy Law Journal* 243.

[24] See the summary of insolvency mechanisms and timetable of changes on http://www.citizensinformation.ie/en/money_and_tax/personal_finance/debt/personal_insolvency/personal_insolvency_options.html, viewed 8 June 2016.

individuals with no assets and a low level of debts (currently up to 47,000NZD). This 'No Asset Procedure' was 'designed to meet the situation of the 'unfortunate' debtor, whose debt has arisen from circumstances such of loss of employment, relationship break-up or some unforeseen life event'.[25] In proposing this procedure, the Government acknowledged 'that the debtor usually cannot avoid bankruptcy and therefore the punitive and deterrent effects of the current regime are inappropriate and have limited relevance'.[26]

As noted above, AFSA most recent Profile of Debtors (2011) shows that just over half of bankruptcies involved unsecured debts of less than $50,000,[27] and that 64% of bankrupts had no realisable assets.[28] Thus, a large proportion of bankruptcies in Australia involve people who are in similar circumstances to those for whom the No Asset Procedure in New Zealand was developed. Reducing the default bankruptcy period to 12 months in Australia can be justified on similar grounds to those justifying the introduction of the NAP.

Bankruptcy law reform involves the balancing of the interests of debtors, creditors, and the community as a whole. In his article, King discusses in detail the different interests and how the discharge policy can best balance those interests. He concludes:

> It is submitted that on balance, the relevant particular interests reviewed above support a short discharge period; that is, one that does not extend significantly beyond the investigation into the bankrupt's affairs. The social utility theory supports a short discharge period in the community interest, because it encourages creditor monitoring, reduces reliance on community welfare programs, minimises the administrative cost of bankruptcies and restores a debtor to economic productivity more quickly. The entrepreneurship theory justifies a short discharge period in the community interest because it fosters risk-taking for the benefit of the economy. A short discharge period is in the debtor's interests under the humanitarian theory because it minimises any emotional and psychological impact of bankruptcy.[29]

We agree with this analysis. In our view, an overly long bankruptcy period has the potential to be punitive, and contribute to, and reinforce, bankruptcy stigma.[30] In the absence of evidence of widespread misconduct or a frequent tendency for bankruptcy to be used as a first resort, a long bankruptcy period serves little purpose. Creditors and the community can be adequately protected with the continuation of the objection to discharge and offences regimes, the continuation of the obligation on the bankrupt to assist in the administration of bankruptcy after discharge, and, in appropriate circumstances, the continuation of an income contributions requirement for a period

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[25] Trish Keeper (2014) New Zealand's No Asset Procedure: A Fresh Start at No Cost?' 14(3) *QUT Law Review* 79, 91.
[26] Ibid 86, quoting from the relevant Cabinet Paper.
[27] AFSA, above n 18, 20.
[28] Ibid 25.
[29] King, above n 6, 686.
[30] Howell and Mason, above n 22, 1571-2.

after discharge. We therefore support the proposal to reduce the default period of bankruptcy to 12 months.

Proposal 1.1

The Government proposes to retain the trustee's ability to object to discharge and to extend the period of bankruptcy to up to eight years.

We support the proposal to retain the trustee's ability to object to automatic discharge on the grounds set out in s149D of the *Bankruptcy Act*. This ability to object to discharge provides an important mechanism for dealing with misconduct, while enabling the majority of debtors to benefit from the shortened default bankruptcy period. However, we note, if only the default period of bankruptcy were amended, there would be a significant difference between the default period (12 months), and the extended period where objections are made on other than the 'special' grounds (5 years). Perhaps consideration could be given to whether an intermediate period of extension is also needed.

Proposal 1.2.1

The Government proposes to change the Bankruptcy Act to ensure the obligations on a bankrupt to assist in the administration of their bankruptcy remain even after they have been discharged to allow for the proper administration of bankruptcy.

We support this proposal, and it is consistent with the current arrangements under s152. However, consideration should be given as to whether s152 needs to be amended to reflect a wider scope of assistance (currently, s152 only requires assistance in the realisation or distribution of vested property).

Proposal 1.2.2

The Government proposes to separate the obligation to pay income contributions from the default bankruptcy period. Instead, individuals will continue to pay income contributions for three years even with the reduction in the default bankruptcy period. Further to proposal 1.1 above, where the period of bankruptcy is extended to five or eight years, income contributions will also be payable for that extended period.

Continuing an obligation to make income contributions after discharge from bankruptcy may be inconsistent with a fresh start policy and interests of debtors. However, the interests of creditors also need to be taken into account in determining the appropriate policy. AFSA statistics show that over $48 million was recovered in income contributions during 2013-14 (including voluntary

contributions),[31] and this is a substantial amount. If the income contribution obligation ceased after 12 months, there is potentially an amount of income that will no longer be available to creditors.

However, a proposal to extend income contributions beyond discharge does bring some additional administrative costs and requirements. For example, the trustee will be required to make an annual assessment of liability to make an income contribution; the (now discharged) debtor will be required to provide information about their income to the trustee (s139U currently only applies to bankrupts), and be required to ensure that the trustee has current contact details (s80 only applies to bankrupts). Some amendment to the legislation might be needed to facilitate this.

AFSA statistics show that, in 2013-14, contributions were required to be paid in 6,453 bankruptcies,[32] but it is not known what percentage this amount represents of the total bankruptcies in force during the same time period. Extrapolating from the reported income of bankrupts at the time of bankruptcy, however, suggests that the proportion might be relatively low. The income contribution obligation currently begins where the debtor has incomes of a net income of around $54,000 (or a higher amount if the debtor has dependents). However, AFSA's 2011 Profile of Debtors shows that nearly half of debtors (43%) were not employed at the time of bankruptcy,[33] and more than three-quarters (78%) had incomes below $50,000 at the time of bankruptcy.[34]

Thus, it might be expected then that a significant proportion of bankrupts will be unlikely to be in a position to be required to make income contributions in the three years following bankruptcy. Imposing a universal obligation to assess contributions beyond discharge therefore may be unwarranted cost. Perhaps an alternative is to have differential application of the income contribution obligation after discharge. For example, the legislation could provide that the income contribution obligation applies after discharge only where the debtor has been assessed to make income contributions during bankruptcy or where the trustee reasonably believes that the debtor's income will exceed the income contribution threshold in the two years post-discharge.

Proposal 1.3.1a

The Government proposes to reduce credit restrictions under the Bankruptcy Act to one year, subject to any extension for misconduct.

We support this proposal.

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[31] AFSA, *Table 3: Bankruptcies in which contributions were paid*, https://www.afsa.gov.au/resources/statistics/selected-statistics/rates-of-return-1/table-3-bankruptcies-in-which-contributions-were-paid.
[32] AFSA, *Table 3: Bankruptcies in which contributions were paid*, https://www.afsa.gov.au/resources/statistics/selected-statistics/rates-of-return-1/table-3-bankruptcies-in-which-contributions-were-paid.
[33] AFSA above n 18,17.
[34] Ibid 18.

Proposal 1.3.1b

The Government proposes to retain the permanent record of bankruptcy in the National Personal Insolvency Index.

The Proposals Paper notes that the permanent record of bankruptcy in the NPII 'ensures that credit providers have the ability to confirm the previous bankruptcy status of any potential debtors'. Presumably, it is on this basis that the Government proposes to retain the permanent record of bankruptcy in the NPII.

However, while we appreciate the rationale for credit providers being able to access personal insolvency information, we question the need for this information to be permanently available to anyone, to be used for any purpose, upon payment of a (small) fee.

As we have argued previously, the permanent public availability of bankruptcy and other personal insolvency information in the NPII has the potential to have unwarranted adverse consequences for individuals in areas of their lives where a previous bankruptcy or insolvency is likely to be minimally, if at all, relevant.[35] It can therefore significantly hinder the achievement of bankruptcy's fresh start objective.

In particular, we note that an employer or prospective employer can search the NPII, and use information from the NPII in employment decision making. The extent to which employers do use insolvency information in decision making in Australia is not known, but in the USA, studies suggest that many employers do use insolvency and/or other credit information.[36] The reasons that employers seek such information include perceptions about a link between bankruptcy and personal characteristics such as dishonesty, tendency to fraud, or irresponsibility.[37] However, there is little empirical evidence to support these perceptions,[38] and the permanent, public availability of the NPII can therefore unfairly restrict access to employment opportunities. Having access to employment opportunities will often be critical to recovery after bankruptcy,[39] and the fact that the NPII can currently be used by employers in this way, without restriction is of concern.

We also note that, in a related area, employers are not permitted to access consumer credit reports; this is presumably to prevent employers using this information to make adverse assumptions. Bankruptcy information is of a similar ilk, and should not be available, either at all, or on an unrestricted permanent basis, to employers for use in employment decision making. There also may be other circumstances in which access to bankruptcy information is an unfair and unwarranted

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[35] See generally Howell and Mason, above n 22.
[36] Ibid 1560-61.
[37] Ibid 1563-4.
[38] Ibid 1564-6.
[39] See for example, a study in the United States that found that those who reported being financially worse off after bankruptcy were more likely to have suffered a drop in income of 10% or more since bankruptcy: Katherine Porter and Deborah Thorne, 'The Failure of Bankruptcy's Fresh Start' (2006) 92 *Cornell Law Review* 67, 81.

intrusion into the achievement of the fresh start. In our view, the extent to which personal insolvency information should be permanently and publicly available to any person, for any reason, needs review.

Query 1.3.1

The Government seeks views from the public on whether it is appropriate to reduce the retention period for personal insolvency information in credit reports.

We do not have firm views on this point, but suggest that, where there are financial incentives for insolvency administrators and services providing debt advice to promote one insolvency administration in preference to others, there should be a consistent approach to the retention of information in credit reports, so as to avoid debtors being steered into inappropriate options. We also note that any changes to the length of time that personal insolvency information is contained in credit reports will need to be proportionate to the length of time that other information (eg, defaults), is retained in credit reports.

Proposal 1.3.2

The Government proposes to reduce the overseas travel restriction to one year, subject to any extension for misconduct.

We support this proposal.

Proposal 1.3.3

The Government proposes to consult with relevant industry and licensing associations with a view to aligning restrictions with the reduced period of bankruptcy, where appropriate.

We support this proposal, but also believe that a more proactive stance is needed. We have previously undertaken an initial review of employment restrictions imposed on bankrupts and former bankrupts, and have found that the circumstances in which bankruptcy (and other personal insolvency administrations) will be a mandatory or discretionary bar to participation in a particular occupation are difficult to identify, often inconsistent, and appear to lack a consistent and justifiable policy rationale. [40]

There are variations and inconsistencies in the restrictions imposed across different occupations and across different jurisdictions within Australia. In addition, even in the absence of a specific occupational restriction, there are various occupations where participants are expected or encouraged to operate as a company and the ban on managing a company while bankrupt has an impact. Further, there are various professional associations (such as lawyers) that require applicants for membership to disclose if they are, or have been, disqualified from managing a company, or are or have been involved in a personal insolvency administration. This may have an adverse effect on persons entering or remaining in particular occupations where membership of a relevant professional association is expected, if not compulsory.

[40] See discussion in Howell and Mason, above n 22, 1538-50.

We note that, in the UK, changes have been made to reduce the impact of bankruptcy on different occupations, and this has been replaced, in part with a Bankruptcy Restrictions Order or Undertaking.[41] This allows for a more nuanced approach to dealing with people who have been bankrupt, and minimises the extent to which bankruptcy has an adverse impact on the employment and business opportunities of persons who are 'unfortunate' bankrupts.

We therefore believe that a more fundamental review is needed of the circumstances in which a current or previous bankruptcy (or indeed another personal insolvency administration) is genuinely relevant to an individual's ability to carry out different occupations, and for what length of time. And without such a review, it will not be possible to identify where it will be 'appropriate' to align restrictions, or indeed change or remove restrictions in another way.

Once such a review is undertaken, existing regimes should be amended to be consistent with the identified public policy justification for imposing such restrictions.

Prohibition of discrimination on the grounds of bankruptcy

Related to the question of the employment and business restrictions imposed on persons who are, or have been, bankrupt, is the issue of discrimination against such persons. As we noted above, anyone can access bankruptcy information, and use it to make adverse decisions, including employers or potential employers. While it might be appropriate to use a former bankruptcy in decision making about providing credit, it is arguable that such information is likely to be minimally, if at all, relevant in a range of other important social areas that are crucial to the achievement of a fresh start, including employment and housing. However, in Australia, there is nothing that proscribes discrimination on the grounds of bankruptcy.

In its recent report on personal insolvency, the World Bank noted 'the principle of *non-discrimination* is an important consideration in achieving the full benefit of a discharge';[42] and that this issue of discrimination against current and former bankrupts is one that required attention in the future.[43] We agree, and believe that attention paid to this issue needs to encompass the issue of discrimination includes discrimination in business and employment contexts. In the USA, there are proposals at State and Federal level to restrict discrimination on the grounds of bankruptcy,[44] and we believe that consideration should be given to whether similar proposals are needed here.

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[41] See https://www.gov.uk/government/publications/bankruptcy-restrictions-orders-and-undertakings/bankruptcy-restrictions-orders-and-undertakings.

[42] The World Bank, Insolvency and Creditor/Debtor Regimes Task Force, Working Group on the Treatment of the Insolvency of Natural Persons 2013, *Report on the Treatment of the Insolvency of Natural Persons*, 116.

[43] Ibid 117.

[44] Bob Lawless, 'The Evidence on Pre-Employment Credit Checks' on Bob Lawless et al, Credit Slips: A Discussion on Credit, Finance, and Bankruptcy (2 January 2014) http://www.creditslips.org/creditslips/2014/01/the-evidence-on-pre-employment-credit-checks.html.

Safe harbour

Safe Harbour Model A

Proposal 2.2

It would be a defence to s588G if, at the time when the debt was incurred, a reasonable director would have an expectation, based on advice provided by an appropriately experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time, and the director is taking reasonable steps to ensure it does so.

The defence would apply where the company appoints a restructuring adviser who:

(a) is provided with appropriate books and records within a reasonable period of their appointment to enable them to form a view as to the viability of the business; and

(b) is and remains of the opinion that the company can avoid insolvent liquidation and is likely to be able to be returned to solvency within a reasonable period of time.

The restructuring adviser would be required to exercise their powers and discharge their duties in good faith in the best interests of the company and to inform ASIC of any misconduct they identify.

Query 2.2

Subject to the further information on the proposal set out in the sections below, the Government seeks views from the public on whether this proposal provides an appropriate safe harbour for directors

The Proposals Paper sets out two options designed to deal with the change to the insolvent trading prohibition. The first is the development of the defence to existing prohibitions. This was the approach advocated by the recent Productivity Commission Report on Business Set-up, Transfer and Closure.[45] It was stated there that the majority of submissions favoured that it operate as a defence stating that the "*main reason for favouring a defence was its private nature and the effect that would have on the prospects of a successful restructure".* The Commission agreed arguing that a defence is the best option to encourage good corporate governance and improve opportunities for restructure.

This first option whilst being in much more detail has the advantage of greater certainty in terms of the conditions that must be met. However, whilst it is very difficult to be definitive because of the lack of data available as to what is motivating behaviour within corporate boards in this area, we would submit this approach may not assist much in encouraging innovation and restructuring. We submit that the first option creates a more restrictive approach and perpetrates one of the difficulties with the current legislation; that is, that the provision is too legalistic and restrictive in the context of making commercial decisions for many companies. The result is that many smaller entities will continue to ignore altogether the legislation prohibiting insolvent trading whilst the larger and better informed boards may adopt a too cautious approach with concern about all of the particular requirements to be met.

This first proposal will presumably (like the other defences in s 588H) leave the onus on the director to establish whether the conditions have been met. As is demonstrated by the case law, it is very difficult to find any cases where a defence has been successful. Directors may well fear a "hindsight factor" whereby they are faced with a situation where the restructure has failed and blame is being sought for the loss. It is possible even that in such a situation that the restructuring advisor may also seek to shift the blame to the director arguing that the director failed to provide proper information. It is not entirely clear where the advisor would sit *vis a vis* the board (or indeed other major stakeholders) when there is a disagreement if it is being suggested that the advisor has some form of independent duty to the company.

[45] Productivity Commission *Business Set-up, Transfer and Closure Report No 75*, 30 September 2015 at 381

Query 2.2.1a

The Government seeks views from the public on what qualifications and experience directors should take into account when appointing a restructuring adviser and whether those factors should be set out in regulatory guidance by the Australian Securities and Investments Commission, or in the regulations.

Query 2.2.1b

The Government seeks views from the public on which organisations, if any, should be approved to provide accreditation to restructuring advisers if such approval is incorporated in the measure.

In looking at the detail of the proposal, the first matter is that it is necessary to decide on a "restructuring advisor". Whilst this seems as if it will be defined legislatively, it means that the legislation will create a regulated segment of the advisory market. This of itself may well be expensive in the sense that it will need to be overseen by a body (presumably ASIC?) and will lead to questions about what education/experience requirements are suitable? No doubt currently registered practitioners represent a potential pool but it is difficult to deny that other skills may be required. [46] Hence it would be very narrow if the pool were restricted in this way. Another issue to consider is that here is currently very little by way of well-resourced programmes in this area. It is acknowledged that at QUT Faculty of Law we offer a graduate certificate in insolvency with one unit in restructuring law and practice. There are smaller units in the ARITA program as well but it is not a situation where clear post graduate rigorous education is widely available in Australia. Almost all materials are from other jurisdictions. We would submit that these matters make the first option problematic in that if the aim of the changes is to allow restructuring and innovation to flourish, there will be a need to create a limited restrictive entry market for those who can advise.

Query 2.2.2b

Do you agree with our approach to disclosure?

Whilst it seems clear that continuous disclosure will run counter to one of the major aims of restructuring out of the formal insolvency procedures – *viz*. ensuring that there is a lack of publicity regarding the financial distress - it is difficult to see how the disclosure regime could operate effectively if this were to be somehow carved out. Therefore, we would support that the continuous disclosure obligations should remain. We suggest however that this raises an important aspect of the proposals that was highlighted in the introduction to this submission: This is that the proposals put forward here – even if desirable in their own right- are extremely limited and will not have sufficient impact on their own to significantly alter the culture around rescue. A much more fundamental

[46] See for example Slatter, S., Lovett D., and Barlow L., *Leading corporate Turnaround: How Leaders fix troubled companies* (John Wiley & Sons, 2006)

analysis of the insolvency regime - both personal and corporate – is required and more comprehensive changes made to make any form of significant change in commercial behaviour and attitudes.

> *Query 2.2.1d*
>
> *What factors should the restructuring adviser take into account in determining viability? Should these be set out in regulation, or left to the discretion of the adviser?*
>
> *Query 2.2.1e*
>
> *The Government seeks views from the public on whether these are appropriate protections and obligations for the restructuring adviser, and what other protections and obligations the law should provide for.*

A further difficulty with the approach in Model A is that the proposal would create a new standard of "viability" rather than the traditional "insolvency . Although this is suggested to be defined in terms of avoiding liquidation and being returned to solvency in a reasonable time, it will be necessary for advisors to determine what a "reasonable time" to return to solvency is. Again they may well take a cautious approach which could defeat the purpose of the legislation. If this option were adopted, it would not seem desirable for the legislation to specify what factors should be taken into account as the variety of situations suggest it is best left to the advisor's expertise. Whilst this option is likely to be more supported by the insolvency profession because of its focus on the appointed advisor, it can be questioned as to whether it enhances the aims of the changes.

Query 2.2.3

The Government seeks views from the public on in what other circumstances should the safe harbour defence not be available.

It is not clear from the proposals document whether the ability of ASIC or the Court to determine that a safe harbour defence was not available because of prior conduct would be happening in advance or only ex post any claim by a liquidator or ASIC. In order to properly comment this needs to be clarified. However, if the proposal is that ASIC would identify recalcitrant directors in advance and make it clear that they cannot seek to restructure the company, then it would present problems. Will ASIC be in a position to police this at the required level? Shouldn't such persons be banned from being a director altogether if they cannot be trusted to meet the conditions of the defence? Thus it seems to open up a different set of considerations beyond just the insolvent trading prohibition. If somehow the Courts or ASIC are allowed to determine if the defence is not available *ex post* the liquidation, then that seems problematic if the conditions of the defence were otherwise met. How could a director ever be sure that they will not be harshly judged with the benefit of hindsight?

The quarantining of certain Commonwealth debts also raises some difficulties. It is not entirely clear how this would operate. Is the proposal to be that there would be no defence if those particular debts are not paid in full or would it be that those particular must be paid and the other creditors can suffer. Again if it is the former, it may be asked how does this assist in achieving the objects of changes? That is are the potential benefits which flow from restructure to be lost because one particular creditor is unpaid? If the proposal is that the directors must be made personally liable for the Commonwealth's debts in this area, it can be asked does this sit with the now accepted position that Crown does not get priority in winding up. We submit that much greater clarity is needed in this area if the first option is to be adopted.

Safe Harbour Model B

Proposal 2.3

Section 588G does not apply:

(a) if the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and

(b) the person held the honest and reasonable belief that incurring the debt was in the best interests of the company and its creditors as a whole; and

(c) incurring the debt does not materially increase the risk of serious loss to creditors.

Query 2.3

The Government seeks your feedback on the merits and drawbacks of this model of safe harbour.

The second option (Model B) seems most likely to facilitate the adoption of a "rescue culture" within financially distressed businesses. This is because it removes the restrictive nature of the requirements in the defence proposal. It seems from the proposal document that the matters raised under Model A would be considered in determining the reasonableness of the steps taken but it would not be specified in the legislation. This would seem to be much more consistent with the policy aim of creating flexibility in the response to financial distress. Although many may see this as a significant loophole with respect to the obligations under s 588G, we submit it is necessary because the current prohibition fails to allow the accepted policy aims of facilitating restructure to be achieved. Model A is unlikely to be a significant enough change to materially alter behaviour in this area. A more general statement is needed to provide boards with the ability to work with interested parties to develop restructuring proposals in a multitude of situations in which companies find themselves. This model avoids the regulatory structure necessary to give effect to model A in terms of identifying and regulating the advisory practitioners. Model B allows parties to seek appropriate advisors by requiring reasonable steps to be taken. It also seems to avoid the necessity to specify what debts are "in" and which debts the defence does not apply to, although this may not be entirely clear from the proposal paper.

One difficulty though is that this wording places the onus on the liquidator to establish that the "carve out" should not have been available. Having regard to the costs of litigation it seems that, like for s 588G itself, such actions may be somewhat rare. Nevertheless, the current situation with s 588G is that few actions are brought. Like with Model A, there is terminology here which would need to be tested in the courts so that there may be some initial uncertainty. However, this is not seen as an insurmountable difficulty in that both models will have this issue to a certain extent.

The Ipso Facto Model

Proposal 3.2 The Government proposes that any term of a contract or agreement which terminates or amends any contract or agreement (or any term of any contract or agreement), by reason only that an 'insolvency event' has occurred would be void. Any provision in an agreement that has the effect of providing for, or permitting, anything that in substance is contrary to the above provision would be of no force or effect.

Proposal 3.2 to constrain ipso facto clauses is supported in the interests of promoting restructuring and maximising value of debtors' assets. Objectives stated in the preamble to the Model Law which is a schedule to the *Cross-border Insolvency Act 2008* (Cth) relevantly include:

- Protection and maximization of the value of the debtor's assets; and
- Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

We do not comment on the more detailed aspects of Proposal 3.2 other than to note that these appear to largely address issues raised by the *UNCITRAL Legislative Guide on Insolvency Law* (2005). This Guide succinctly outlines the different approaches and issues surrounding such clauses, concluding its discussion as follows:

> "118. … there are, nevertheless, circumstances where the ability of the insolvency representative to ensure that a contract continues to be performed will be crucial to the success of reorganization and also, but perhaps to a lesser extent, liquidation where the business is to be sold as a going concern. For these reasons, it is desirable that an insolvency law permit such clauses to be overridden. Any negative impact of a policy of overriding these types of clauses can be balanced by providing compensation to creditors who can demonstrate that they have suffered damage or loss as a result of the contract continuing to be performed after commencement of insolvency proceedings, or including exceptions to a general override of these clauses for certain types of contracts, such as contracts to lend money and, in particular, financial contracts (see … paras. 208-215).
>
> 119. Where an insolvency law provides that termination clauses can be overridden, creditors may be tempted to take pre-emptive action to avoid that outcome by terminating the contract on some other ground before the application for insolvency proceedings is made (assuming a default by the debtor other than one triggered by commencement of the proceedings). Such a result may be mitigated by providing that the insolvency representative has the power to reinstate those contracts, provided both pre- and post-commencement obligations are fulfilled."

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27 May 2016