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Our Ref: MEL
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23 January 2018

By Email: seniorclerk.committees.sen@aph.gov.au
Original forwarded by Post

Committee Secretary
Senate Legal and Constitutional Affairs Committee
PO BOX 6100
Parliament House
CANBERRA ACT 2600

Dear Secretary

Submission to the Senate Legal and Constitutional Affairs Committee on the *Bankruptcy Amendment (Enterprise Incentives) Bill 2017.*

I welcome the opportunity to make the following submission in relation to the *Bankruptcy Amendment (Enterprise Incentives) Bill 2017* (**Bill**). In the event the Committee convenes public hearings and wishes to hear further on any aspect of this submission then I will endeavour to make myself available in that regard.

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Executive Summary

1. I support the reduction of the standard period of bankruptcy from three years to one year. However I do not support this on what I consider an illusory premise of supporting entrepreneurship. Rather it is a means to eliminate perceived failings that may diminish public confidence in the existing bankruptcy regime.

2. 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 period of bankruptcy beyond one year. The existing regime of objections will not provide adequate support to trustees in bankruptcy to enforce compliance with a bankrupt's obligations in a one year bankruptcy under the *Bankruptcy Act 1966* (**Act**)

Personal Background

By way of background I am a partner of the national law firm Piper Alderman. I have practiced for over 25 years in insolvency and reconstruction law having particular expertise and experience in bankruptcy law which continues to form

a material segment of my law practice. I am a former national chair of the Law Council of Australia's Insolvency and Reconstruction Committee, a current member of the ARITA Victorian/Tasmanian State Committee and a former representative of the Law Council of Australia on the Bankruptcy Reform Consultative Forum previously convened by the office of the Attorney-General. 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.

This submission constitutes my personal views and does not necessarily constitute the opinion of my firm Piper Alderman.

Challenging the underlying premise of the Bill

The General Outline to the Explanatory Memorandum to the Bill (**EM**) states the aim of the Bill is to "*foster entrepreneurial behaviour and to reduce the stigma associated with bankruptcy. Reducing the automatic discharge to one year will reduce stigma, encourage entrepreneurs to re-engage in business sooner and encourage people, who have previously been deterred by punitive bankruptcy laws, to pursue their own business ventures*"

I have previously made a submission, dated 24 May 2016, to Treasury in response to the Proposals Paper dated April 2016 titled "Improving Bankruptcy and Insolvency Laws". I have restated herein a large part of that submission.

No evidence has been put forward to support the objective of the Bill. Indeed what evidence does exist suggests that the vast majority of bankrupts are anything but entrepreneurs.

Sometimes referred to as the "high flyer" amendments, the *Bankruptcy Amendment Act 1991* was enacted to address the conduct of a number of the then bankrupt "luminaries" of the entrepreneurial world that graced the corporate failures of the late 1980's such as Christopher Skase and Alan Bond.

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

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:

> *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;* [2]

This response had been flagged almost two years earlier by the then Minister for Justice and Customs, the Honourable Senator Vanstone. In a paper[3] 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.*

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[1] *Explanatory Memorandum to Bankruptcy Legislation Amendment Bill 1991* @ para 2
[2] Copy Press Release attached
[3] Copy attached

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 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 that may conflict with the very societal attitudes seen as so important such a short time ago. My concern is that the Bill 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 being 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.

Further, the reduction to a one year bankruptcy will likely render largely redundant post-bankruptcy arrangements with creditors under section 73 of the Act. Bankrupts will have no incentive to put a proposal to creditors when bankruptcy ends in one year.

I have previously posed the rhetorical question for an officer of the Australian Financial Security Authority (AFSA), which administers the vast majority of bankruptcy administrations, Have you been able to identify any entrepreneurs within the many thousands of bankrupts AFSA administers?

The point of such question is that the profile of the average bankrupt does not paint a picture of entrepreneurs being held back.

AFSA have previously published biennially, a profile of debtors utilising one of the administrations under the Act. The last profile published was in relation to the 2011 year[4]. This document usefully maps the profile of the average debtor and the changes 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:*

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

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 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 [5]contains an analysis of causes of bankruptcy in the 2015-2016 and 2016-2017 years. It includes the following which are extracted directly from the website:-

Main non-business related cause of personal insolvency	**Number of insolvent debtors in 2015–16**	**Number of insolvent debtors in 2016–17**
Excessive use of credit	7,697	8,870
Unemployment or loss of income	8,336	8,035
Domestic discord or relationship breakdown	3,083	3,222
Ill health	1,882	1,830
Gambling or speculation	542	525

[5]www.afsa.gov.au

Adverse legal action	500	386
Liabilities due to guarantees	293	232
Not stated	376	565
Other non-business reason	1,760	1,560
Total	**24,469**	**25,225**

Main business related cause of personal insolvency	**Number of insolvent debtors in 2015–16**	**Number of insolvent debtors in 2016–17**
Economic conditions	1,921	1,779
Personal reasons, including ill health	325	471
Excessive drawings	334	310
Lack of business ability	256	283
Excessive interest	169	224

Lack of capital	203	155
Failure to keep proper books	158	113
Inability to collect debts	111	107
Gambling or speculation	38	56
Seasonal conditions	65	29
Other business reason	2,054	2,143
Total	**5,634**	**5,670**

The large volume of non-business bankruptcies as a proportion of total bankruptcies and the demographic of the average bankrupt does not support a conclusion that entrepreneurial spirt and opportunity is being suppressed by reason of a three year period of bankruptcy. If a spark of entrepreneurship is being suppressed by bankruptcy laws then the absence of evidence leads one to infer that it is only in a minority of cases. Having regard to the societal concerns expressed by Senator Vanstone in 2000 and the Attorney-General in 2002 one must question why these amendments are now being proposed for what at best is an ill-defined minority.

The EM also notes the potential for business failure and the consequences of bankruptcy serve as a discouragement to entrepreneurs. No evidence is proffered to support this. One might well contend that risk, for which entrepreneurs are renowned, ought not be so unfettered as to minimise economic consequences of ones actions.

In my professional experience bankruptcy continues to be perceived in the wider community 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.

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 the existence of a robust mechanism to extend bankruptcy in appropriate cases, the period of bankruptcy should be reduced to one year.

The Official Trustee in Bankruptcy is trustee of the vast majority of bankrupt estates, most of which are "consumer bankruptcies" in which there will never be a realisation or return to creditors and where there has been no conduct warranting particular sanction. The Official Trustee is not resourced to conduct its administrations with the same diligence expected of registered trustees. It has managed its duties through implementation of systems and the referral of overflow work to registered trustees but there remains a perception that bankruptcies administered by the Official Trustee are not as stringently administered as with a registered trustee. In making this observation I do not seek to criticise the office of the Official Trustee and/or AFSA which is faced with the unenviable task of having to allocate limited public resources. However these perceptions can diminish public confidence in the existing regime.

It has long been a matter of debate[6] as to how to equitably deal with these consumer bankruptcies while not creating a split system whereby business bankruptcies are treated differently and thus inviting avoidance and abuse.

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 enable those bankrupts suffering the misfortune of business failure to resolve their bankruptcies sooner is an incidental benefit.

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[7]. To the extent a bankrupt is to be punished for culpable conduct then the offence regime is intended to address such conduct.

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[6] I am familiar with this issue through my term on the Bankruptcy Reform Consultative Forum .

[7] See generally *Inspector-General v Nelson* (1998) 86 FCR 67

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 they can force removal of an objection through then meeting such obligations as required. This leads to material delay and cost in the administration of bankruptcies.

By way of typical example (with which I am directly familiar) a trustee may be frustrated in the conduct of investigations through 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 will ordinarily be required to remove the objection because objections are not to punish but to procure performance. Once discharged there is no incentive for the bankrupt to co-operate at all. More importantly 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 fees. These costs create a material obstacle/disincentive for Trustees in determining how far to pursue lines of inquiry. To suggest that these realities are unknown in the market place by those advising bankrupts would be naïve.

In answer to the above it has been suggested that certain grounds of objection do not require a trustee to state reasons for the objection. While this is correct it does not relieve the trustee of the duty to consider a request by a bankrupt to review whether or not there is an ongoing basis to maintain an objection. If the purpose of the objection (to encourage compliance) has been met and there is no other legitimate basis to maintain the objection the case law supports the removal of the objection.

If there is to be a reduction of the standard period of bankruptcy to one year then then the price for that should 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 a stick should obligations be ignored in the first place. To the extent that objections are therefore to be a punishment for obdurate failure to perform obligations then that should be 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 as a penalty for repeated failures to comply with obligations. A framework for such penalty might extend the bankruptcy to 3 years following certain objective failures by the bankrupt and following appropriate warning (akin to a "three strikes and you're out" rule). It should be treated as a penalty and therefore not subject to reasons. A right of review to set aside such objection for other sufficient cause by a bankrupt should be included as a safeguard to bankrupts against capricious conduct by a trustee.

A further new ground of objection that might be considered is where there is 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. 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 procured through having the period of bankruptcy continued.

If insolvent debtors are to be relieved of the consequences of two years of bankruptcy then to ensure public confidence in the bankruptcy regime is maintained, consistent with the sentiments expressed the former Minister and former Attorney-General as set out above, then there is a good case for strengthening the objection regime.

Specific Comment on Schedule 1 to the Bill

Items 1, 2 and 8	There is an obvious conflict between these clauses. In 1 it states the obligation to pay of the bankrupt in the first bankruptcy ceases. Yet in 2 it says the new trustee gets to exercise the same rights as in the first bankruptcy. In clause 8 the definition of contribution assessment period (CAP) does not include a period in an earlier bankruptcy. Query therefore how a successive trustee is to conduct an assessment for the earlier CAP. As drafted this may relieve the bankrupt of any obligation in the first bankruptcy.

If the Committee has any queries arising from this submission please do not hesitate to contact me.

Yours faithfully
Piper Alderman

Per:

Michael Lhuede
Partner