Submission to Senate Committee on Legal and Constitutional Affairs

Bankruptcy Amendment (Enterprise Incentives) Bill 2017

Commercial and Property Law Research Centre, Faculty of Law, Queensland University of Technology

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This submission is made by members of the Commercial and Property Law Research Centre (CPLRC), Faculty of Law, Queensland University of Technology (QUT). Thank you for the extension of time to allow us to lodge this submission.

About the Commercial and Property Law Research Centre (CPLRC)

The CPLRC is a specialist network of researchers with a vision to reform legal and regulatory frameworks in the commercial and property law sector through high-impact applied research. Through our collaborations with government, industry and institutions, we aim to lead cutting-edge research that will improve and contribute to knowledge, policy and practice.

Members of the Debt, insolvency and restructuring unit of the Research Centre explore issues relating to credit provision, financial distress and business recovery. With strong connections to Australian and international insolvency bodies, our members are research leaders in areas of:

- Consumer credit and consumer debt;
- Regulatory responses to personal insolvency;
- Corporate insolvency and business restructuring;
- Cross-border insolvency and restructuring; and
- Secured transactions.

The context of bankruptcy reform

The major change proposed by the Bill is to reduce the default period of bankruptcy from 3 years to 12 months. This proposal has been adopted following recommendations in the

Productivity Commission's Report on Business Start-ups, and according to the Explanatory Memorandum, aims to:

> foster entrepreneurial behaviour and reduce the stigma associated with bankruptcy whilst maintaining the integrity of the regulatory and enforcement frameworks for the personal insolvency regime.

We note, however, that, as with other personal insolvency law reform proposals in recent years, discussions about this proposal suffer from the absence of detailed evidence of the impact of bankruptcy on stigma, entrepreneurialism, and other matters. We made this observation in a submission by CPLRC members in 2016.

There is also a law reform pattern of addressing specific issues in personal insolvency in isolation, rather than as a part of a comprehensive review of the totality of the personal insolvency system. We also note that proposals are difficult to assess in the absence of a contemporary agreement about the goals of bankruptcy and personal insolvency generally. The 1988 Law Reform Commission's *General Insolvency Inquiry* report (the Harmer report) listed the principles of a modern insolvency system as the following:

- "The fundamental purpose of an insolvency law is to provide a fait and orderly process for dealing with the financial affairs of insolvent individuals and companies.
- Insolvency law should provide mechanisms that enable both debtor creditor to participate with the least possible delay and expense.
- An insolvency administration should be impartial, efficient and expeditious.
- The law should provide a convenient means of collecting or recovering property that should properly be applied toward payment of the debts and liabilities of the insolvent person.
- The principle of equal sharing should be retained and, in some areas, reinforced.
- The end result of an administration, particularly as it affects individuals, should, with very limited exceptions, be the effective relief or release from the financial liabilities and obligations of the insolvent.
- Insolvency law should, so far as is convenient and practical, support the commercial and economic processes of the community
- As far as is possible and practicable, insolvency law should harmonise with the general law.
- An insolvency law should enable ancillary assistance in the administration of an insolvency originating in a foreign country." [1]

We also note more recent commentary that suggests that attention should also be given to debtor rehabilitation in personal insolvency. For example, in a 2013 report for the World Bank, a Working Party on Personal Insolvency has argued that:

[1]Law Reform Commission (1988) *General Insolvency Inquiry* (Report no 45), 15-17.

> One of the principal purposes of an insolvency system for natural persons is to re-establish the debtor's economic capability, in other words, economic rehabilitation. [2]

Academic commentary also takes a wider perspective on the role of bankruptcy and other personal insolvency options.

For example, in his introduction to *Personal Insolvency in the 21st Century*, Professor Iain Ramsay argues that (our paraphrasing):

- recessions triggered by large increases in household debt can result in slower economic recovery than those triggered by other events;
- swift and effective insolvency procedures during a recession to reduce the household debt overhang could therefore have a valuable macro-economic effect by restoring consumer demand in the economy;
- bankruptcy discharge itself reduces lost productivity and costs to families and communities, and creates incentives for responsible lending and accounting practices, and allocating the risk of losses to those in the best position to spread those risks;
- the EU sees personal insolvency law as part of the development of an integrated credit and capital market; and
- in the early part of this the twenty-first century, personal insolvency law had become a significant market institution.[3]

Similarly, in reference to the UK situation, Professor Ramsay and Dr Joseph Spooner have written:[4]

> "Writing off debts after a recession may have important benefits by permitting individuals to make a fresh start, be more productive, and undertake new credit obligations. The IMF recognized these facts in chapter 3 of the 2012 World Economic Outlook suggesting that a long and slow deleveraging process for individuals after a household debt bubble may retard economic recovery. Freeing households to borrow and spend may be particularly important in an economy as dependent on consumer demand as that of the UK. Bankruptcy can reduce the externalities of over-indebtedness such as illness and family conflict and creditors are forced to account for the consequences of bad or irresponsible lending decisions. The fear of moral hazard—that individuals will run up debts in a risky manner knowing that they can discharge them in bankruptcy—is a concern but evidence suggests that this is a relatively modest problem and most modern bankruptcy systems have mechanisms to protect against moral hazard by consumers".

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[2] Working Group on the Treatment of the Insolvency of Natural Persons (2013) *Report on the Treatment of the Insolvency of Natural Persons* (The World Bank, Insolvency and Creditor/Debtor Regimes Taskforce, Report 77170), 115.
115

[3] Iain Ramsay (2017) Personal insolvency in the 21st century: A comparative analysis of the US and Europe (Hart Publishing)

[4] Iain Ramsay and Joseph Spooner (2014) 'Why so few bankruptcies in England and Wales?' (https://creditdebtandinsolvency.wordpress.com/2014/05/02/why-so-few-bankruptcies-in-england-and-wales/, May 2, 2014).

Bankruptcy and personal insolvency law therefore has a major role to play in the economy, and the proposals in this Bill should be considered taking into account the above principles and perspectives.

In 2016, members of the Commercial and Property Law Research Centre provided a detailed submission to the Treasury on proposals to amend insolvency laws, including the proposal to reduce the duration of bankruptcy, and we attach the submission here.

Current knowledge base

Before commenting briefly on the specific proposals in the Bill, we provide here for the Committee's reference, a summary of recent statistics, and academic and other studies that are relevant to an assessment of the proposed changes.

Impact of bankruptcy on debtors

One point that CPLRC members made in our 2016 submission is that discussion on personal insolvency law reform was hampered by the lack of empirical evidence on the impact and experience of bankruptcy. Since then, however, researchers associated with Melbourne Law School have conducted several studies that can help inform the Senate Committee's deliberations on this Bill.

Based on survey research with 167 current and discharged bankrupts (recruited through a PureProfile survey panel)[5], Ali et al report that most debtors found that bankruptcy improved their:

- ability to manage their finances (77% reported an improvement);
- ability to manage their day-to-day living expenses (74% reported an improvement);
- mental health (61% reported an improvement);
- relationships and family life (57% reported an improvement); and
- physical health (55% reported an improvement).[6]

Although the method of recruitment for this survey means that the findings cannot necessarily be generalised to the population, the positive outcomes reported in this study highlight the very significant effect that bankruptcy can have for people who have overwhelming debts, often as a result of an unexpected and uncontrolled for event.[7] These findings also suggest that for many debtors, bankruptcy does achieve its 'fresh start' or debtor rehabilitation goal.[8]

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[5] Paul Ali, Lucinda O'Brien and Ian Ramsay (2017b) 'Bankruptcy and debtor rehabilitation: an Australian empirical study' 40 *Melbourne University Law Review* 688, 702- 704.

[6] Ibid 706.

[7] The most common causes of bankruptcy, as nominated by debtors are: unemployment or loss of income; excessive use of credit; and domestic discord or relationship breakdown; and ill health (https://www.afsa.gov.au/statistics/causes-personal-insolvency).

[8] Ali et al, above n 5, 691 – 694.

However, Ali et al also note that the benefits of bankruptcy are not necessarily equally shared, with discharged bankrupts reporting more positive outcomes than debtors who were in a current bankruptcy.[9] This suggests that *reducing* the period of bankruptcy is therefore likely to bring to an earlier time the positive impacts that bankruptcy has for many debtors.

Bankruptcy and entrepreneurialism

A key driver for the Bill is stated to be to encourage business entrepreneurialism. We note, however, that most bankruptcies are in fact a result of consumer debts, rather than business debts.

We quote from AFSA's submission:

> "In the 2017 calendar year 24.7% of bankruptcies were categorised as business related. Since the March quarter 2003:
>
> • on average, 21 .5% of bankruptcies were business related each quarter
>
> • business related bankruptcies have fluctuated between 12.9% of bankruptcies (September quarter 2009) and 28.2% (September quarter 2012)".

The entrepreneurialism objective is therefore relevant for only a small proportion of the people that currently use the bankruptcy system. As Ali et al have noted:

> 'AFSA's data indicates that the vast majority of bankrupt debtors are not failed corporate entrepreneurs, but instead, come from relatively modest socioeconomic backgrounds."[10]

Bankruptcy and stigma

The proposal seeks to reduce the stigma of bankruptcy to encourage entrepreneurialism. As we note above, the entrepreneurialism objective is likely to be relevant to only a relatively small proportion of bankruptcies. Further, the extent to which the changes will directly facilitate this objective in personal bankruptcy is not clearly argued by the government. On this point, we note that, for business-related bankruptcies, the most common reasons for bankruptcy (in the December 2017 quarter) were:

- Economic conditions;
- Excessive drawings; and
- Lack of business ability.[11]

These are issues that seem unlikely to be affected by a reduction in bankruptcy stigma.

Recent survey research in Australia suggests that the public has a negative attitude towards people who are, or have been, bankrupt. Ali et al surveyed people on their responses to the prompt 'I think that people who go bankrupt ...'. The most common responses were:

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[9] Ibid 711.

[10] Paul Ali, Lucinda O'Brien and Ian Ramsay (2017) 'Misfortune or Misdeed: An Empirical Study of Public Attitudes Towards Personal Bankruptcy' 40(3) *UNSW Law Journal* 1098, 1109

[11] See https://www.afsa.gov.au/statistics/commentary.

- Are bad at managing their money (65%);
- Are extravagant or greedy (36%);
- Deserve sympathy (31%);
- Are unlucky (24%).[12]

However, the authors also report a divergence in attitudes towards business bankrupts and consumer bankrupts, with survey respondents regarding the latter as more deserving of sympathy.[13] The authors conclude by suggesting that:

> … it seems likely that a reduction in the discharge period for business-related bankruptcies might in fact increase the stigma attaching to bankruptcy, by reinforcing the association between bankruptcy and unscrupulous entrepreneurs. By contrast, the survey suggests that Australians might be more amenable to the Government's proposed reforms if these are cast as a means of assisting ordinary consumers who become overwhelmed by debt and need help to start again.[14]

Risk of debtor abuse

Some commentary about the proposed decrease in the duration of bankruptcy has raised concerns that it will increase the potential for abuse by debtors. However, there is little evidence of wide-spread abuse of the bankruptcy system in Australia.

For example, we note from AFSA's submission that there were only 519 objections to discharge lodged in 2016-2017 in relation to the 57,923 persons who were in bankruptcy, a factor of .009%. This suggests that, overall, there is relatively little improper behaviour associated with the bankruptcy system.

We also note that, in England, the introduction of a 12-month bankruptcy period was accompanied by the introduction of Bankruptcy Restrictions Orders designed to impose restrictions on culpable bankrupts. However, the proportion of BROs is low relative to the number of bankruptcies,[15] supporting the argument that bankruptcy abuse is a relatively infrequent occurrence.

Necessary time for administration of bankruptcy

One aspect of the duration of bankruptcy is that it should provide sufficient time for the administration to be completed. To our knowledge, there is no published information about the average time needed to complete a bankruptcy administration. However, where debtors have low incomes and few assets, as is the case for many bankruptcies, it is likely that the time needed for necessary investigation and administration of a bankruptcy may be relatively short.

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[12] Paul Ali, Lucinda O'Brien and Ian Ramsay (2017) 'Misfortune or Misdeed: An Empirical Study of Public Attitudes Towards Personal Bankruptcy' 40(3) *UNSW Law Journal* 1098, 1116.
[13] Ibid 1123-4.
[14] Ibid 1129.
[15] For example, Katerina Moser (2013) 'Restrictions after personal insolvency' [2013] *Journal of Business Law* 679, 689 (There were 879 BROs in 2011/12, compared to 41,876 new bankrupts in 2011).

Of course, there are likely to be some bankruptcies where more detailed and time-consuming investigation and administration is required. However, it seems unlikely that this will be necessary for most bankruptcies. More information on this aspect provided by AFSA would, however, assist here.

Income contributions

One aspect of the proposal is that debtors may be required to make an income contribution in the two years after being discharged from bankruptcy. Such a proposal impinges somewhat on the potential of the shortened discharge period to facilitate a 'fresh start' for debtors, however, it can perhaps be justified if it addresses other objectives of the bankruptcy system (for example, providing funds for creditors).

This proposal should therefore be considered in light of the extent to which bankrupt debtors are likely to be assessed to make an income contribution. Here we note:

- In 2011 (more recent figures have not been published),78% of bankrupts reported an income at the time of bankruptcy of less than $50,000, and 52% reported an income of less than $30,000.[16] The income threshold at which a single debtor (with no dependents) was required to make an income contribution at the end of 2011 was $47,265.[17] Thus, it could be assumed that a large majority of bankrupt debtors would not have been assessed to make an income contribution if their situation remained unchanged during bankruptcy.
- In 2011 (more recent figures have not been published), 53% of debtors reported being unemployed at the time of bankruptcy, with nearly have reporting that they had been unemployed for 12 months or more.[18] It might be assumed that for many of this group, their employment status may have remained unchanged during bankruptcy.

Figures from AFSA also suggest that the bulk of income contributions are made by people whose bankruptcy is administrated by a registered trustee, however, these administrations represent only a minority percentage of bankruptcies.[19] In 2014-15, income contributions of $7,763,535 were made in respect of bankruptcies administered by the Official Trustee, and income contributions of $40,649,655 were made in respect of bankruptcies administered by registered trustees.[20] While these figures might seem large, they are in the context of more than 61,000 new bankruptcies in the preceding three years.[21]

Some figures we have obtained[22] indicate that while income contributions represent about 20% of total receipts of the Official Trustee, and about 12% for registered trustees, we consider that much of those moneys would go to the remuneration of the Official Trustee

[16] ITSA (2011) *Profile of Debtors* 2011, 18.
[17] See https://www.afsa.gov.au/sites/g/files/net1601/f/newhistoricalindexed.pdf_1.pdf.
[18] Ibid 17-18.
[19] In 2014-15, 19% of new bankruptcies were administered by a registered trustee: AFSA 'New bankruptcies administered by trustees', available from https://www.afsa.gov.au/statistics/annual-administration-statistics.
[20] See AFSA, 'Monies administered by the Official Trustee under Parts IV and VI of the Bankruptcy Act'; and 'Monies administered by registered trustees under Parts IV and VI of the Bankruptcy Act', available from https://www.afsa.gov.au/statistics/annual-administration-statistics.
[21] AFSA 'New bankruptcies administered by trustees', available from https://www.afsa.gov.au/statistics/annual-administration-statistics.
[22] AFSA has also provided us at our request with unpublished figures for 2016-17; these can be made available.

and of the registered trustees, not to the creditors. The remuneration is therefore for the work involved in administering a bankruptcy for three years, and beyond.

A point we make from this is that the present system, based on a 3-year period of bankruptcy operates on the need for income contributions to be secured for that period in order to fund the work involved over that 3-year period.

In fact, we also point out that the 2016-17 figures provided to us by AFSA[23] show that dividend returns for estates administered by the Official Trustee average 0.84 cents in the dollar. That is understandable given that the Official Trustee administers largely assetless consumer bankruptcies. However, the 2016-17 figures also show that the average dividend return for estates administered by registered trustees is only 1.30 cents in the dollar. It is those estates that contain most of the more complex and business-related bankruptcies. On the basis of these figures, a creditor with a $10,000 claim would receive dividends of $84 and $130 respectively.

Response to specific proposals

Automatic discharge after 12 months

While greater empirical evidence would have informed this debate, the proposal to reduce the default period of bankruptcy to one year:

- is consistent with the Harmer principles for a modern insolvency system and the World Bank's views on the goal of debtor rehabilitation
- would be generally consistent with comparable jurisdictions (eg, the UK, Canada (9 months), and the USA);
- would better facilitate a rehabilitation-focused 'fresh start' for debtors; and
- could help to reduce the stigma of bankruptcy in the community. That stigma is in part reinforced by the long three-year period of bankruptcy (although as noted above, this is likely not to be the only cause of stigma). A lesser period would reduce the perception of a penal sentence being imposed. The reduced stigma should reduce the risk of people being dissuaded from using the bankruptcy option when it is the most appropriate option for their circumstances. It should also reduce the length of time that bankrupts and discharged bankrupts from suffering adverse effects in relation to access to employment, housing and essential services.
- goes some way towards compensating for the absence of a No-Income, No-Assets insolvency procedure for low income debtors, such as is available in New Zealand[24] and the United Kingdom.[25]

We note also that nothing in the Harmer report, nor later commentary, supports a view of bankruptcy being about punishment of debtors.[26] Given the serious implications and

[23] See n 22.
[24] No Asset Procedure, Insolvency Act 2006 (NZ) Part 5, subpart 4.
[25] Debt Relief Order, Insolvency Act 1986 (UK), Part 7A.
[26]Paul Ali, Lucinda O'Brien and Ian Ramsay (2015a) 'Short a few quid: bankruptcy stigma in contemporary Australia' 38(4) *UNSW Law Journal* 1575, 1597-99.

restrictions of bankruptcy, requiring all debtors to remain in bankruptcy beyond a period of time that is needed to meet the objectives of, for example, effective administration of the bankruptcy and distribution of relevant funds to creditors, primarily has a punitive effect.

Referring also to the *Harmer* principles above, we suggest that, if a bankrupt has no 'property that should properly be applied toward payments of the debts and liabilities of the insolvent person', the interests of the creditors are not advanced by an extended period of bankruptcy. Further, the administrative costs of keeping a bankruptcy on foot if there is no such property, and no realistic prospect of any such property, is inconsistent with the goal of an administration that is 'efficient and expeditious'.[27]

Of course, bankruptcy and discharge from bankruptcy alone may not be sufficient for all debtors to improve their financial position. Additional, more holistic approaches (including approaches outside the bankruptcy legislation) may also be necessary.[28] However, in the absence of efforts towards some of these other measures, a shortened discharge period is likely to go some way towards facilitating bankruptcy's fresh start for many debtors.

However, if the proposal is implemented, consideration may also need to be given to appropriate mechanisms for ensuring there is sufficient time for investigating and administering more complex bankruptcies and detecting and deterring fraudulent conduct.

Any system can be abused, and bankruptcy does lend itself to those who will transfer or hide assets, or not cooperate with their trustee. There are still mechanisms in place to counter those, and that will often be the task of the trustee. The law can address abuse, but overall it should not prejudice the honest and unfortunate debtor, and this includes the uninformed, uneducated, and those who are objectively foolish or rash.

Income contributions

If most bankrupts are unlikely to be required to make an income contribution, the proposal to require all bankruptcies to be assessed for income contributions in the post-discharge period appears to impose additional costs for limited return to creditors. In this context, we refer back to the *Harmer* principles noted above.

A blanket requirement for post-discharge assessment for income contributions may therefore be unwarranted.

Instead, a more targeted approach could be adopted, using one or more of the following criteria:

- Requiring an income contribution assessment post-discharge only if a person has been required to make an income contribution during their bankruptcy.
- Requiring an income contribution assessment post-discharge only if the trustee has reason to believe that the person will earn income about the threshold in the two-year period after bankruptcy. This assessment could be made based on factors such as debtor's current and any previous occupation and salary level, and any likely prospects for change. For example, a sales assistant who has been unemployed for the duration of

[27] Law Reform Commission, above n 1, 15.
[28] For example, Ali et al suggest more is needed by way of information and support for debtors before and after bankruptcy, and also argue for an increase in Newstart payments (Ali et al, above n 5, 732-4).

the bankruptcy is unlikely to earn above the income threshold even if their employment situation reverses. A trustee's decision could be appealed, as is currently the case.

- Requiring an income contribution assessment post-discharge only if the bankruptcy is administered by a registered trustee.

Adopting a targeted approach along these lines would reduce the costs of administrating the bankruptcy and increase the reality of the fresh start for most bankrupts, whilst having little adverse impact on the amount of income contributions payable to creditors (with the reduced costs of administration likely to offset any small reduction in income contributions). The concern expressed in the Explanatory Memorandum about high income earners 'abusing bankruptcy laws by reducing their income for a year, hiding their assets, accruing excessive debt and only being subject to income contributions for a one-year period' (para 42) can be addressed by existing protections against fraudulent conduct, and by the trustee's ability to assess the likelihood of future income contributions against past income and employment situations.

Obligation to provide contact details

We support the proposed amendments to s80(1) in relation to the obligation to advise the trustee of a change in contact details, including by providing a specific time frame. To the extent that communications between a bankrupt and AFSA, the Official Trustee or a registered trustee may also be made by email, perhaps this section should also include reference to an email address. We agree with AGD's submission[29] that this should not be subject to a penalty of imprisonment.

Although we have suggested above that a post-discharge income contribution assessment should not necessarily be required for all former bankrupts, if the proposed provisions on income contribution are maintained, we support the obligation to provide a change of contact details for the two-year period post-discharge.

Objections to discharge

We support the retention of the regime for objecting to automatic discharge. However, we suggest that, if the default period of bankruptcy is reduced to one year, an interim period of extension (less than 5 years) would be appropriate.

Other law reform issues

We reiterate comments from CPLRC members in previous submissions about the need for a holistic review of personal insolvency laws, the role that they are expected to play in the community, the way in which the different options work together, and the links between personal and corporate insolvency regimes, particularly for business bankrupts. We also urge for detailed consideration of related issues, including those of discrimination against current and former bankrupts (particularly in areas other than credit decision-making); the retention of the NPII as a permanent public record; occupational restrictions affected by bankruptcy and other persons insolvency administrations; and the treatment of income

[29] Submission 17.

received during bankruptcy when an income contribution is not required.[30] A new ‘Harmer’ report is well overdue.

In support of that holistic approach, we note that ASIC’s submission to this Inquiry refers to a consequence of a one-year bankruptcy being that ASIC “may well be required to take steps to disqualify relevant persons as directors more frequently … pursuant to ASIC's powers at s.206F Corporations Act”. That may well be, and it shows that bankruptcy has a far-reaching impact and influence elsewhere, including in state laws. Continued ad hoc reform of personal insolvency laws does not ensure a personal insolvency system that is internally and externally coherent.

Contact

We would be pleased to clarify any issues arising from this submission. Please contact Nicola Howell on or in the first instance.

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[30] See discussion in Christopher Symes and Mark Wellard (2014) ‘After-acquired income and contributions by Australian bankrupts: can pay, should pay, making them pay’ 14(3*) QUT Law Review* 53, 76-77.