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SUBMISSION

Submission No: 35

**BANKRUPTCY LEGISLATION AMENDMENT
(ANTI-AVOIDANCE AND OTHER MEASURES) BILL 2004**

This Submission addresses the Terms of Reference of the inquiry by the House of Representatives Standing Committee on Legal and Constitutional Affairs into the exposure draft of the Bankruptcy Legislation Amendment (Anti-Avoidance and Other Measures) Bill 2004.

The Submission is divided into four parts.

- Executive Summary.
- Examples.
- Existing Remedies.
- Impartial Inquiry.

We request the opportunity to supplement the Submission by attending before the Committee. This will also enable Committee members to obtain responses to any questions they may have.

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EXECUTIVE SUMMARY

1. The problem identified in the Taskforce Report

The Taskforce was established to determine whether any changes are needed to the bankruptcy and taxation laws to ensure that people are prevented from using bankruptcy as a means of avoiding their tax obligations.

The Taskforce was of the view that special protection is required to prevent a small number of high-income professionals using bankruptcy to avoid meeting their tax obligations.

The Taskforce had no mandate to, and did not inquire into whether the special protection should extend to all creditors.

2. Special protection for taxation obligations

It is unacceptable for high-income professionals to not meet their tax obligations and frustrate recovery by having assets owned by family members.

We agree with the Taskforce that taxation obligations are different from other obligations and require special protection from such action.

3. How the draft Bill addresses the tax problem

The approach in the draft Bill is without precedent in Australia and, as far as we know, in any country overseas. It has not been subject to public inquiry nor consultation.

The draft Bill seeks to address the tax problem by having a Court work out in the bankruptcy of an individual what the Court considers appropriate between the members of the bankrupt's family and all creditors (tax or otherwise).

Those familiar with property disputes before the Family Court will be only too well aware of the arbitrariness, uncertainties, difficulties and delays involved in such disputes. When creditors are added to the dispute, we consider this will be compounded many times over. The lawyers acting for the parties will be the principal beneficiaries.

Under the draft Bill transactions are not void – rather the whole matter is left to the Court in its discretion to work out what to do. We consider this is to be conceptually flawed, commercially undesirable and unfair to members of the bankrupt's family, particularly the bankrupt's spouse. Furthermore, it is unlikely to deter the type of high-income professional who has in the past used bankruptcy to avoid tax obligations. At best he will get away with the transaction and at worst, he can have his family members seek the exercise of the discretion to keep all or part of the assets.

4. How to address the tax problem

In our view bankruptcy is not the place to address the tax problem. By then it is often too late or too difficult to unwind the past. Rather the Commissioner of Taxation should have power under the Taxation Act (regardless whether the taxpayer is bankrupt) to set aside any gift or other transaction at undervalue with any family member or associate which occurred within a specified period.

5. Professional negligence claims

Professional negligence claims were not a subject the Taskforce was required to consider. It did not do so, and in consequence, did not identify any problem with professionals using bankruptcy to defeat such claims.

As no such problem was identified, it is not appropriate, without a proper impartial inquiry, to make these claims the subject of the draft Bill.

For too long the complex social and economic issues centre around who bears the loss or damage arising from the acts or omissions of professionals and others has been swept under the carpet. It is not acceptable to frustrate claims by having assets in the names of family members or associates. Nor is it acceptable for there to be no affordable insurance which is available immediately to fully meet such loss or damage.

It is suggested that this aspect should be the subject of a separate inquiry, or become a part of the work already in progress by the Government on the subject, so that a comprehensive solution is provided.

6. Other debts

Other debts were also not the subject of the Taskforce inquiry or report.

No problem was identified by the Taskforce requiring the law to be changed. Accordingly no change should be made.

7. Those most adversely affected

If the draft Bill is enacted those most adversely affected will be ordinary Australians. For example, if they run a small business they may lose all family assets or be involved in a costly legal dispute (which would involve creditors selling up the matrimonial home and taking assets saved for retirement). This will encourage consumption – not saving.

Further, it will be increasingly difficult to find financial advisers and accountants prepared to advise on how to invest when the adviser could lose all his family assets if sued for negligent advice. In addition, there would be an absence of company directors prepared to take on the risk of managing investments.

Australia is dependent on small business and on a strong financial investment system. The draft Bill will adversely effect this, and will stifle entrepreneurship and risk taking by small business.

8. Amendments to Bankruptcy Law

Successive Governments in Australia and England have recognised the necessity to fairly balance the competing claims in bankruptcy. We detail in part four of this Submission how in the past no major change in bankruptcy law has occurred without extensive public inquiry and consultation.

The Taskforce Report is not impartial or balanced as regards an amendment to bankruptcy law. The draft Bill contains unprecedented and far reaching changes – an impartial public inquiry, consultation and a well thought out report is required.

9. Conclusion

We consider that the Standing Committee should carry out an impartial inquiry and extensive consultation on the draft Bill (after receiving a report on the matter from the Australian Law Reform Commission) - similar to that carried out by the Senate Standing Committee on Bankruptcy Legislation Amendment Bill 1995.

If the Government considers that the tax problem requires immediate action, the Tax Act should in the meantime be amended to provide protection in the manner mentioned above.

EXAMPLES**1. Example**

John worked as a manager for Qantas and was made redundant at 50 years of age. He received a redundancy payment of \$300,000 and immediately went with his wife, Joan, on an overseas trip.

On returning he tried for six months to find another job - but without success. Ultimately in frustration he decided to go into business for himself and opened a coffee shop.

In the following year his daughter Sally asked him for help in buying a unit for her and her child to live in.

John discussed the matter with Joan and they decided to give Sally \$50,000 for this purpose.

The daughter paid \$150,000 for the unit and borrowed the remaining \$100,000 from the bank.

For the next ten years John, with the help of Joan ran the shop.

John then became ill with Alzheimer's disease. As the illness progressed he increasingly neglected the shop. The shop was close to his daughter's unit and he frequently stayed there, to save the long drive to his own home.

Ultimately John was forced to close the shop - owing his creditors \$250,000 (largely unpaid rent). John used all his resources to keep the business going and his only remaining asset was his half share in the family home - worth \$175,000.

The creditors who were owed the \$250,000 forced a sale of John and Joan's home so that they could receive John's half share - this left \$75,000 still owing.

If the draft Bill becomes law the creditors will be entitled to make John bankrupt and apply to the Court for Sally to pay them the greater of \$50,000 or one quarter the present value of her unit.

2. The wide scope of the draft Bill

The Example illustrates that the draft Bill is not limited to professionals – whether high income or not. It applies to anyone – including small business, retirees, employees, company directors, financial planners, tradesmen, property owners (occupiers liability), the sick and the elderly.

Nor is the draft Bill limited to income tax liabilities. It applies to any liability.

Further it is not limited to where bankruptcy is used by the bankrupt to avoid paying tax or any other liability. It applies where creditors force the person into bankruptcy.

3. What defences are available?

Sally would be the defendant in the proceedings brought by the creditors. As her father frequently stayed at her unit he would be treated under the draft Bill as having benefited from the gift.

Sally's sole defence would be to try and prove that John's main purpose in giving her the \$50,000 was not to defeat, delay or impede his creditors. Sally has the onus of proof. Her father is presumed guilty.

Unfortunately by the time the matter is to be heard by the Court John's illness makes it difficult for him to remember the gift made over ten years previously. John's doctor advises against him going into the witness box and being subject to cross examination.

Sally has little practical choice but to try and do a deal with the creditors outside the Court. The creditors are seeking the greater of \$50,000 or one quarter of the present market value of the unit - plus their legal costs. Sally is forced to pay the \$50,000. She does not have the money and has to borrow from the bank. She also has to pay her own legal costs of \$7,000.

4. Is the bankrupt presumed guilty unless innocence is proven?

Yes, under the draft Bill the bankrupt is presumed guilty unless innocence is proved.

This is not only objectionable in our democratic system - but in practice innocence may often be difficult to prove. What Sally in the above example is seeking to prove – without the benefit of her father’s evidence - is her father’s subjective purpose many years ago.

5. Does it make any difference that the bankrupt took all reasonable and practical steps to make sure all creditors were paid?

No, it makes no difference. The creditors are still entitled to make the person bankrupt and bring the application. In the Example it would not matter that John did everything he could to make the coffee shop a financial success. It would also not matter that John used all of the family savings to this end, and that he and his wife were left with nothing. Nor would it make any difference that the landlord of the shop was able to release it to another tenant immediately at a much higher rent.

6. Does it make any difference that the creditors provided credit with reference only to the assets in John’s name?

No, it makes no difference that in providing credit the creditors did not take in account the money given to Sally.

7. Does it make any difference that the bankrupt was solvent at the time the gift was made?

No, it makes no difference that John in the Example was solvent at the time the gift was made and remained so for over ten years thereafter.

8. Will the draft Bill have retrospective effect?

Yes, the draft Bill will have retrospective effect. It would apply, for example, to anything done by a bankrupt in 1950, 1960, 1970 and onwards. Accordingly, if John in the Example was made bankrupt in 2005 and the draft Bill were law, the Bill would apply to a gift made to Sally 20 or 30 or more years earlier.

This means that John and Sally would have lost the opportunity to document John's purpose at the time of the gift. This is particularly significant when Sally has retrospectively the onus of proof imposed on her.

9. If a bankrupt's innocence cannot be proved why is there a concern – after all the Court has a discretion what to do?

The draft Bill is deliberately drawn widely with the intention that there will be many situations where it would be wrong for the creditors to get all or any part of the assets in dispute. To deal with this the draft Bill leaves the matter entirely in the hands of the court. This creates uncertainty, the risk of the unknown and high legal costs in proving innocence. It would be hardly surprising if many people simply gave up and tried to do the best deal they could with the creditors outside the Court.


Whilst Sally in the Example might bitterly resent her father being treated as guilty, she would have little practical alternative. Faced with creditors with deeper pockets than hers and with relatively little to lose – the contest is hardly equal.

10. What happens if the bankrupt may have had a mixed purpose in making the gift?

In the Example, what happens if John's wife Joan after having been told about John's plan to open a coffee shop begins to worry that something might go wrong, particularly as John had no business experience. A short time later John gave her his half interest in the family home as a surprise wedding anniversary present.

Ten years later when he is made bankrupt the creditors who are owed the \$250,000 bring a court application to obtain the half interest in the matrimonial home that John gave to Joan.

How can Joan in the above circumstances prove that John's main purpose was not to defeat or delay future possible creditors when it was her concerns about creditors which preceded the transfer. But John may only have been placating his wife - without any intention to defeat his creditors – how can Joan prove this now?



EXISTING REMEDIES**1. Existing Remedies**

Under the Bankruptcy Act 1996 gifts and other transactions for undervalue entered into by a bankrupt with family members and associates are in prescribed circumstances void.

Within two years of bankruptcy

Any payment or other transfer of property for an undervalue made within two years of bankruptcy is void regardless of whether the bankrupt was insolvent at the time of payment or transfer; s120.

There is a limited number of exceptions, one of which is a payment or transfer to meet a liability under a family maintenance agreement or order; s120(2).

Within two to five years of bankruptcy

Any payment or other transfer for an undervalue made within two to five years of bankruptcy is void where the bankrupt was insolvent at the time of payment or transfer; s120.

The recipient of the payment or of the transfer has the onus to prove that at the time of the transfer the bankrupt was solvent; s120(3).

There is a limited number of exceptions, one of which is a payment or transfer to meet a liability under a family maintenance agreement or order; s120(2).

Payments or transfers to defeat creditors

Any payment or transfer of property made at any time prior to bankruptcy can be set aside where the main purpose of the bankrupt was to put the asset outside the reach of creditors (present or future).

A bankrupt is taken to have such a main purpose if it can be reasonably inferred from all the circumstances that at the time of the payment of transfer the bankrupt was insolvent or about to become so; s121(2), (3).

There is no exception for payments or transfers to meet a liability under a family maintenance agreement or order.

Property obtainable from controlled entities

The Trustee in Bankruptcy can apply to the Court for an order against a company or other entity controlled by the bankrupt where the entity benefited from the services of the bankrupt within 2-4 years of the commencement of the bankruptcy; s139A-s139H.

The typical situation which the provisions contemplates is where the bankrupt's family company employed him on a low wage and the company was paid the market rate by third party for the bankrupt's services.

2. Additional remedies under the draft Bill

Under the draft Bill it is proposed that the above remedies remain and in addition the creditors would have power to challenge any transaction entered into with a family member at any time prior to bankruptcy. Where the transaction was a gift or otherwise at undervalue, the creditors need only prove that the gift or transaction occurred, and that the bankrupt received some form of consequential benefit, no matter how fleeting, or infrequent, or how long ago. In the Example, a benefit would be John staying at Sally's unit.

Once the above is proved the recipient of the property or money in any transaction at undervalue(usually a gift), such as Sally in the Example, has the onus to prove that the main purpose of the bankrupt in making the gift was not to ensure what was given would not be available to pay existing or future creditors.

IMPARTIAL INQUIRY

1. The Taskforce

The members of the Taskforce were the Attorney-General's Department, Australian Taxation Office, Insolvency and Trustee Service Australia and the Department of Treasury.

The Taskforce was not an independent or impartial inquiry into how to balance the interests of creditors with the competing claims in bankruptcy having regard to the social and economic issues involved.

The function of the Taskforce was to identify the extent of the problem and determine whether any changes were needed to the bankruptcy or taxation laws to ensure that people were prevented from using bankruptcy as a means of avoiding their tax obligations. To this end Taskforce was required to liaise closely with the Commonwealth Director of Public Prosecutions and the Australian Federal Police.

2. Lack of impartiality, public inquiry or consultation

Given the nature of the task assigned to the Taskforce there was no necessity for it to be impartial or to have a public inquiry or consultation into any proposed amendments to the Bankruptcy Act.

The lack of such impartiality, public inquiry or consultation is of no concern in determining the existence and extent of the problem. It is, however, of concern when considering whether and then how to amend the bankruptcy law.

3. Reports on proposed changes to the bankruptcy law

Bankruptcy law involves a complex range of social and economic issues. Successive Governments in Australia and England have recognised the need for an impartial and public inquiry and consultation before any changes are made.

Some of these inquiries are listed below:

- The present Bankruptcy Act 1966 is the result of a Report prepared by a Committee headed by Sir Thomas Clyne, the then Federal Judge in bankruptcy. The Report was a result of a review carried out between 1956-1962 and most of the recommendations are contained in the Bankruptcy Act.
- Following developments in business and increasing insolvency in Australia and overseas the Attorney-General in 1976 issued terms of reference to the Law Reform Commission to consider whether the Bankruptcy Act made adequate provision for small or consumer debtors to discharge or compromise their debts from present or future assets or earnings. In response, the Law Reform Commission issued its report No. 6, Insolvency: the Regular Payment of Debts, 1977, making a number of recommendations to update and appropriately develop the Bankruptcy Act. The Commission also recommended further wide-ranging investigation and review into the application of the Bankruptcy Act to all debtors.
- In response, the Attorney General issued further terms of reference to the Law Reform Commission in 1983 urging the Commission to inquire generally into the law and practice relating to insolvency and bankruptcy having regard to the Commission's earlier findings and the nature of Australian commercial practice and Australian and international law regarding insolvency. The Law Reform Commission held a comprehensive and wide ranging inquiry into the law and practice relating to insolvency and bankruptcy, including public hearings, interviews and discussions with debtors, creditors, government bodies and industry groups, and so on in order to carry out the review. The result was the Law Reform Commission Report No. 45, General Insolvency Inquiry, 1988 ("the Harmer Report"). The Harmer Report recommended a number of significant changes to the law relating to bankruptcy, including provisions dealing with transfer of assets at undervalue and transfers to defeat creditors.
- During the Harmer Report review the Law Reform Commission undertook further specific review of the Bankruptcy Act to address those areas left outstanding by the Commission's 1977 Report. A second report was issued by the Commission arising from the original 1976 terms of reference, in the form of the Law Reform Commission Report No. 36, Debt Recovery and Insolvency, 1987.

- Amongst the wide ranging and fundamental changes recommended by the Law Reform Commission in the Harmer Report, included provisions dealing with fraudulent transfers to defeat creditors. These provisions were proposed to be introduced in the Bankruptcy Legislation Amendment Bill 1995. Given the fundamental importance of the proposed amendments, the Bill was referred to the Senate Legal and Constitutional Legislation Committee for its detailed review and consultation. The Committee held public hearings in Sydney and Melbourne, and received numerous submissions. The Senate Committee issued its report in September 1995 spanning almost 100 pages. A comprehensive and highly detailed Explanatory Memorandum was also issued with the Bill to explain the content of the provisions and their intent.

It is evident from the above, that proposed reviews of or changes to the bankruptcy laws which are of any significance have always been referred to independent committees to review the proposed changes in light of detailed and wide ranging consultation. The Law Reform Commission in the Harmer Report noted "*insolvency law is a matter of considerable importance to the Australian community*" therefore requiring reference for proposed changes to the independent Law Reform Commission for its review.

The Law Reform Commission also noted that major reviews of insolvency and bankruptcy laws in comparable overseas jurisdictions involved detailed review and consultation by independent committees. The Cork Committee was commissioned in 1977 to review the insolvency law of England and Wales. The five year work of the Committee resulted in the Cork Report on Insolvency Law in England and Wales, recommending extensive changes to the law and practice of bankruptcy in that country. In Canada an independent expert report was made in the form of the Colter Report in 1986, in addition to the Tasse Report of 1970, recommending many bankruptcy reform proposals in that country. The United States Bankruptcy Code provisions were enacted only following comprehensive analysis and report by the Commission of the Bankruptcy Laws of the United States and the National Conference of Bankruptcy Judges.

In their extensive report the Cork Committee had this to say on this subject in 1997:

"One suggestion for reform: 'pooling' spouses' assets

1228. We have received numerous complaints that property to which the creditors might have expected to have recourse is often unavailable to them in a bankruptcy, because it is

found to be held in the name of the bankrupt's wife under a title unassailable in the bankruptcy or because the business with which they have been dealing as if it were the business of the bankrupt is, in law, carried on in his wife's name. One solution which has been proposed to us is that when a trader or other person carrying on business is made bankrupt, all the assets of his or her spouse should be pooled with his or her own and made available to meet the creditor's claims, in so far as they relate to that trade or business.

1229. We reject this proposal as an unjustified interference with individual property rights, which would produce an unfair result in many cases, and which in many respects would be a reversion to outmoded concepts of matrimonial property which have long since been abandoned. If the proposal were adopted, elementary notions of fairness would require that the other spouse's owner property, not derived directly or indirectly from the debtor, should be exempt. This would not only lead in many cases to an uncertain and unsatisfactory inquiry, but would in effect tend to reintroduce the Victorian concept of 'the wife's separate property' which was abandoned almost a century ago. We regard the proposal as entirely out of line with modern attitudes to the proprietary rights of husband and wife."

