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BY: Gillian Gould

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Secretary
The House of Representative Standing Committee
on Legal & Constitutional Affairs
Parliament House
CANBERRA ACT 2600

Dear Sir

PROPOSED CHANGES TO THE BANKRUPTCY ACT

On 14 May 2004, the Honourable Mr Ruddock, the Attorney General of Australia, released an exposure draft of changes to the Bankruptcy Act under Press Release number 074/2004.

It is public knowledge, from newspaper articles, that a number (small) of New South Wales barristers have, over long periods of time, failed to lodge income tax returns but, during those periods, accumulated significant assets either in their wives' names or transferred property to spouses – *but from their income*. The media reports flowing form the Attorney General's statement were to the effect that some $20 million tax was at risk and that the trustees in bankruptcy of these barristers (they became bankrupt following action by the ATO) were able to recover only $1 million.

This is despite long standing provisions in the Commonwealth Bankruptcy Act and in various States' legislation to the effect that payments of money or transfers of property with intent to defraud creditors can be overturned by a Court upon the application of a trustee in bankruptcy. There is no time limit on this. (Section 121)

The only reasonable inference to be drawn from a situation where a barrister declines to lodge tax returns over a long period of time but accumulates assets in a related party's name is that he intended to defraud an identifiable creditor, namely, the ATO.

Further, there are other provisions which enable a trustee in bankruptcy to clawback assets transferred within specified times before bankruptcy (two years or five years depending on whether the bankrupt was solvent at the time of the transfer) as well as a set of provisions in Division 4A of Part VI which, if a bankrupt has provided services to a trust for inadequate remuneration, enable the trustee in bankruptcy to seek an order from the Court that part of the trust assets be appropriated towards the trustee in bankruptcy to be applied for the benefit of creditors.

The provisions of Division 4A, although existing in the Act for many years, have not often been used. *There has been no demonstrated deficiency in them.*

In the case of the NSW barristers, matters were complicated because of conflict between the Bankruptcy Act and the Family Law Act. Those are different issues and are being dealt with

Office Level 1 145 Eagle St, Brisbane Qld 4000 **Phone** (07) 3839 5222
Postal GPO Box 761 Brisbane Qld 4001 **Fax** (07) 3839 8488
Email clearlaw@clearyhoare.com.au

separately in the proposed legislation.

Notwithstanding the significant powers already available to trustees in bankruptcy, changes to the bankruptcy law are proposed and those changes are extraordinary:

- Any entity (whether related or not) which has acquired an asset from a person who later becomes bankrupt will have to prove that, when that entity acquired the asset, the bankrupt did not have a tainted purpose.
- A tainted purpose is the desire to protect assets from the exigencies of business, which can befall innocent persons (as distinct from fraudulent attempts to defeat creditors).
- If the entity, ie, a spouse or a trust, is unable to prove the absence of this so called tainted purpose, a Court will be compelled to make orders in relation to those assets with a view to transferring them, or part of them, or part of the value of them (depending on the circumstances) to the trustee in bankruptcy.
- The provisions do not even protect an arms length purchaser, unless the purchaser can prove the absence of tainted purpose. One would think that an arms length purchaser would normally be able to do this, but an arms length purchaser ought not be put to this task.

It is accepted by most that the more successful businesses there are in a country, the more prosperous the country will be. The more prosperous a country is, the better off, with some adjustments for social needs, its citizens' standards of living will be.

The more new businesses that start, then, eventually, the bigger number of successful businesses there will be. Unfortunately, many of the "new starts" will fail – experts calculate the failure rate of more than 50%.

If the businesses are of significant size, then "the risk takers" will want to manage the risk of failure. This can only be *legitimately* done by reliance upon two long standing mechanisms:

- Limited liability.
- Asset protection.

Limited liability has been available for about 160 years (originally in England) and enables the general public to invest in public and private companies, including new ones, in such a way that, whilst they put their investment at risk, the rest of their resources is not at risk. This is because, as shareholders, they are not liable for the debts of the company in which they invest (in many cases, very fortunately).

The use of discretionary trusts for asset protection has been available for more than 400 years (again, originally in England). This concept of asset protection works upon the basis that, whilst the discretionary trust (often called a family trust) will have a wide class of *potential beneficiaries,* none of the beneficiaries has an interest in the trust assets, unless that benefit is allocated to the beneficiary by the trustee. Thus, if a beneficiary of a discretionary trust is subject to a divorce or insolvency, then the assets of the trust *should not* be at risk.

It is through the use of these dual mechanisms that risk takers can afford to take significant risk without necessarily losing the whole of their asset base – which is not in the interests of their families. Robert Gottliebsen, in the Weekend Australian on 22 May 2004, explained the

benefit of "risk taking" and the extraordinary changes proposed to the bankruptcy legislation in an article headed "Bankrupting the spirit of risk". In it, he states:

> "... the family assets of tens of thousands of small businesses and professionals are now at risk. And as the proposed changes would be indefinitely retrospective, there's very little any small business or professional person can do about it."
>
> "Once the proposed changes are understood, they will create an unusual alliance between small business and the professions on the one hand and family and women's rights groups on the other. It will make the refugee campaign look like a side-show."
>
> "A great many Australians have organised their affairs using the protection of this Bankruptcy Act (referring to everyday protection mechanisms which do not contain fraud). It has enabled one person in the family to take risks in their business knowing that the family assets are not in jeopardy."
>
> "Did they (speaking about persons who become bankrupt) transfer assets so that they would not be taken by creditors? While tax and family equity could have been a factor, most realise that they were not salary earners and were taking a business risk, and they did not want their family to be on the streets if they fail. The vast majority did not intend to go bankrupt."

By far the vast majority of businesses that fail do not fail on the basis of any intent to defraud. By far the vast majority fail despite the honest and best efforts of all concerned. Unfortunately, there will always be those who abuse the system. What has "inspired" the proposed changes to the Bankruptcy Act is the abuse of the system by a small number of New South Wales' barristers. Their antics have been well publicised.

Because of those activities, a taskforce made up of representatives from the Attorney General's Department, the Australian Tax Office and the Insolvency Trustee Service of Australia – all Federal Government agencies – has proposed changes which are:

- Retrospective.
- Reverse the burden of proof.
- Draconian.

For over 400 years, discretionary trusts have been used to protect assets, initially from wastage in succeeding generations, and, in recent decades, against the unforeseen exigencies of business activity, including rural activity.

Enclosed with this letter is a series of examples where trusts have played, or could have played, a very significant role in protecting assets where the collapse of the business person (bankruptcy) is not really the fault of that person, ie, it has occurred through unforeseen circumstances.

Not only is the very sound and sensible law of 400 years being completely undermined by the proposed changes, the standard of proof is also to be reversed. *In addition to that, the provisions will act retrospectively, in that they will act in respect of transfers of property and payments of money which have occurred before the legislation was announced. This is to be contrasted with the proposal in the Attorney General's Press Release no R049/2003 on 16 December 2003 under which he proposes to reduce the protection available to the*

bankrupt's superannuation benefits where the contributions to the super fund have been for the purpose of avoiding creditors. In that Press Release, he states that these changes will apply in respect of contributions made after 16 December 2003. Further, those changes are limited to attacking contributions intended to defeat known or reasonably foreseeable creditors.

However, there is no basis to distinguish between the two proposals in terms of retrospectivity. In fact, there is simply no basis for retrospective legislation. It may surprise you to know that the intended retrospectivity reflects your Government Policy (para 89 of the Explanatory Memorandum).

These matters are of serious concern for those who practice in this area and, even more so, they are of serious concern for their clients. *If there are deficiencies in the existing provisions (Section 121 and Division 4A), they should be identified and dealt with specifically.*

The proposed legislation is designed to make life easier for the ATO and insolvency practitioners – at the massive expense of everyone in business.

The vast majority of bankrupts are not Alan Bond, nor Christopher Skase nor Jodie Rich. As Mr Gottliebsen points out:

> "The problem is that the vast majority of bankruptcies involve great suffering for all the parties and a dramatic reduction of living standards.
>
> The Ruddock proposals might be motivated by the laudable aim of acting against New South Wales barrister-type situations, but they catch everybody.
>
> Almost certainly these changes, if enacted, will reduce risk-taking in Australia."

We urge the Committee to focus upon:

- Circumstances which originally drove these changes (the circumstances relating to the New South Wales' barristers and the likes of Bond, Skase and Rich).
- The fact that such abuses are by a very small minority.
- The fact that there *are* provisions in the existing Bankruptcy Act to attack fraudulent activity designed to defeat creditors.
- If there are deficiencies in the Bankruptcy Act, then those who proposed the changes should identify the deficiencies with precision and should recommend precise amendments to deal with those deficiencies – not amendments designed simply to make life easier for the Australian Tax Office and Trustees in Bankruptcy, at the risk of tens of thousands of small business people trying their very best in the hope, and with confidence, that they will succeed, but accepting the risk of failure and desiring to, at least, protect their basic family assets in the event of that failure.

- The necessity of obtaining a balance between honest risk taking, the benefit of risk taking for the community (prosperity) and preventing the abuse of the system.

Yours faithfully

Michael Hart
Managing Principal
Cleary Hoare Solicitors

ASSET PROTECTION EXAMPLES

1. From Central Queensland, more than 40 years ago:

   1.1 A grazing family with significantly sized operations had its own livestock transport fleet. One laden semi trailer collided with a train at a railway crossing, causing significant damage to the train, because of derailment. The railway department sued the grazier for very significant damages. The event caused massive financial hurt to the family and the loss of the property.

   1.2 Properly advised, the family would have had the transport operations in a separate entity, preferably a discretionary trust. Even more preferably, they would have had their other operations, livestock operations and farm ownership in at least one other discretionary trust.

   1.3 If that approach had been taken, the impact on the grazing family would have been limited to the assets held in the trust which conducted the transport operations, ie, the truck fleet.

   1.4 For reasons unknown, insurance was not available to meet the claim against the family. Certainly, in modern times, if the driver has partaken of alcohol above the prescribed limit, insurance coverage will be denied.

2. Brisbane, a little over ten years ago:

   2.1 A professional practice had insurance coverage with FAI, a then large Australian insurer. Action was taken against them, including a senior employee, as a result of what was claimed to be deficiencies in specifications/estimates. The action was taken by a public company.

   2.2 FAI reserved its rights, which really meant that it would not grant cover to the clients but would watch the clients endeavour to defend themselves and then decide whether to grant cover. The clients could not afford this. One of the parties was forced into bankruptcy. Fortunately, the family house was not in his name.

   2.3 Again, the financial calamity which occurred was not through any mal-intent on behalf of the bankrupt. It may well be that the bankrupt was not even negligent. However, he did not have the opportunity to prove otherwise.

3. Queensland, late 1980s:

   3.1 A client owned a state franchise system in a discretionary trust. The same client had a number of other businesses, each in separate trusts. The general manager of the state franchising business defrauded that business. Towards the end, he was placing $2,000.00 each way on each horse at Eagle Farm Racecourse every Wednesday and Saturday.

This resulted in a loss of $500,000.00 to the client. However, the other assets, being held in separate trusts, were not at risk.

3.2 What in fact happened was that the client's bank requested that he provide them with additional security over the other trust assets and, as a matter of honour, the client did – ultimately to his own very significant disadvantage. Nonetheless, this is another instance where financial calamity was visited upon a client without any mal-intent on behalf of the client.

4. Sub contractors – everywhere, anytime:

4.1 It is a notorious fact that many well intentioned sub-contractors encounter financial calamity because the head contractor cannot, or will not, pay the sub-contractor. It has become common usage in the sub-contracting industry, because of these uncontrollable circumstances, for sub-contractors to have their houses owned either in their spouses name or in the name of a trust.

4.2 In future, sub-contractors will not be able to protect their basic assets against the action of head contractors, quite often, fraudulent action.

5. Estate Planning – everywhere, anytime:

5.1 Mum and Dad, in their 60's, have accumulated reasonable wealth, from many years of hard work. They have four adult children, all married with children. They wish to leave their estate for the children and their families, but with the desire to protect what they leave from any financial calamity which might befall their children.

5.2 To achieve this, they set up four discretionary trusts in their Wills, one "earmarked" for each child.

5.3 Mum and Dad die. Later one of the sons becomes bankrupt.

5.4 Because Mum and Dad had an intention to protect the assets they were leaving to the trusts, the trust assets will be available to the son's trustee in bankruptcy (New Section 139AM).