18 June 2004

Submission No: 72

The Secretary
House of Representatives Standing Committee
On Legal and Constitutional Affairs
Parliament House
Canberra ACT 2600

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BY: Gillian Gould

Dear Madam,

INQUIRY INTO THE BANKRUPTCY LEGISLATION AMENDMENT (ANTI-AVOIDANCE AND OTHER MEASURES) BILL 2004

I would like to make the following submission to the Committee.

I am a member of both accounting bodies and a registered liquidator. I have been working in the insolvency profession, mainly at manager level, for over 20 years, during which time I have worked on numerous corporate and personal insolvency administrations, including many bankruptcies.

Unfortunately I have not had enough time to examine all parts of the Bill in detail. However, I have examined the proposed amendments to Division 4A, and have attended lectures and debates on all parts. My comments here are restricted to Division 4A.

Amendments to Division 4A of Part VI

More like a wall than a walnut

The explanatory memorandum states that the proposed amendments are intended to address the issue of high income professionals using bankruptcy as a means of avoiding their taxation and other liabilities. It also refers to 'the problem of a small but significant number of high-income debtors, typically high earning fee-for-service professionals, who use bankruptcy to avoid paying their taxation or other debts".

This alone should be sufficient justification for the proposed amendments. However, the phrase "small but significant number" has been seized upon by opponents to claim that the amendments are like using a sledgehammer to crack a walnut. [1]

[1] As many of these opponents are themselves "high earning fee-for-service professionals", their arguments are being couched in terms of the damage the proposed amendments will do to small business owners and farmers, rather than how their own asset protection arrangements would be placed at risk. They tend also to focus on the reference to taxation debts, perhaps assuming that the community considers such debts fair game anyway.

The problem is, however, much larger than a walnut. Back in 1987, when the existing Division 4A was introduced, the accompanying explanatory memorandum noted:

> "... there is an increasing incidence of bankruptcies involving persons who become bankrupt as a deliberate device to defeat the claims of their creditors. Frequently it is a feature of such bankruptcies that the persons involved have made use of sophisticated and complex commercial structures of companies and trusts as a device to conceal property, the use and enjoyment of which is reserved to the bankrupt but which has the appearance of being owned by the company or trust. Upon a bankruptcy the bankrupt is protected from the claims of the creditors but the secreted property is beyond the reach of the trustee in bankruptcy. Such bankruptcies were commented upon by the Royal Commission on the Activities of the Federated Ship Painters and Dockers Union (the Costigan Royal Commission) which referred to the incidence of 'insolvency fraud'." [2]

That explanatory memorandum also referred to "an increasing incidence of abuse of the corporate veil and other devices as a means of disguising the identity of assets which are acquired, directly or indirectly, through the efforts of the bankrupt, the use of which is enjoyed by the bankrupt, but which have the guise of being the property of an associated entity". [3]

Amendments introduced in 1987 to tackle the problems identified by the Costigan Royal Commission proved to be ineffective, largely for the reasons summarised in paragraphs 33 and 34 of the explanatory memorandum accompanying this (2004) Bill.

As a result, the community, having identified more than 16 years ago an increasing incidence of bankruptcy fraud and devious practice, still has no effective means of defeating and deterring that behaviour.

The proposed amendments are long overdue. I see them as a second attempt at confronting this exploitation of creditors, but this time with the benefit of lessons learnt from the first attempt, plus new and effective legal phrases obtained from proceeds of crime legislation.

And because asset protection arrangements are common throughout the business community, the amendments should bring benefits to creditors in a lot more bankruptcies than simply those of a "small but significant number of ... high earning fee-for-service professionals".

Facilitation of credit

The pursuit and recovery of assets disposed of in order to frustrate or defeat creditors has long been a purpose of bankruptcy legislation.

For example, the doctrine of reputed ownership - which has parallels with the proposed amendments - began in the 17th century. It was contained in the Commonwealth Bankruptcy Act of 1924-1928 [section 91 (iii)] and apparently remained there until 1966.

One of the not-so-obvious reasons for such bankruptcy laws is the facilitation of credit. This has been explained as follows:

> "The provisions of the bankruptcy law prohibiting various malpractices ... maintain order and a higher degree of morality in commercial life. The granting of credit is facilitated, as the creditors know that should the credit be misplaced, as inevitably sometimes happens, they will be protected against fraudulent or unscrupulous debtors and that provisions exist for the best possible satisfaction of their claims. Persons requiring credit, on the other

[2] Explanatory Memorandum to the Bankruptcy Amendment Bill 1987 (page 1).
[3] Explanatory Memorandum to the Bankruptcy Amendment Bill 1987 (page 7).

hand, are not deterred from seeking it, knowing that should they fail in their undertakings, they will not be handicapped for the rest of their lives." (Underlining mine) [4]

The proposed amendments will, if used, restore some faith in creditors that the bankruptcy laws exist for their benefit and not only for the benefit of debtors. This, in time, should facilitate the granting of credit to both unincorporated and incorporated businesses.

The benefits for incorporated businesses should not be overlooked or understated. These days a private company will rarely be granted loans or other finance, including substantial amounts of credit, unless the directors provide the company's creditor with personal guarantees. This means that the company's creditor must consider, not only whether the personal wealth of the debtor/guarantor, but also whether, if and when the guarantor's assets have to be called upon, the bankruptcy laws will provide the best possible satisfaction of the creditor's claim. In other words, the value of personal guarantees – which facilitate the provision of credit to corporations - are enhanced by good bankruptcy laws.

The attitude of registered trustees

I understand that the IPAA is presenting a case on behalf of its constituent registered trustees in private practice, and that they are strongly opposed to the proposed amendments.

The Committee will, of course, consider the IPAA criticisms and suggestions strictly on their merits. However, I believe the Committee should also consider the fundamental conflict of interest faced by registered trustees in private practice and the ambivalence that many seem to have about bankrupts.

Statistics published by the Inspector- General in Bankruptcy show that most bankruptcies arise as a result of debtors petitions, i.e., voluntary bankruptcy. Many of these debtors, especially the ones with assets or complex financial affairs, would have approached one or more registered trustees to discuss their affairs before filing their petition.

At such meetings the debtor would be trying to gauge the trustee's attitude towards him or her, and ascertain the amount that the trustee is likely to charge for his or her services. Regarding attitude, the debtor would be looking for someone likely to go easy or, better still, turn a blind eye in some matters. The debtor certainly would not want a trustee who felt a strong sense of duty to creditors.

On the other hand, the trustee is in business and needs to get clients. The temptation to tell the debtor what he wants to hear is great, as is the tendency to think of the debtor, not the creditors or the court, as his client. Besides the debtor may have been referred to the trustee by friendly accountant or a solicitor from whom the trustee gets plenty of work.

In a sense the last thing the registered trustee placed in this situation wants is for the bankruptcy law to make it easy or impose a duty upon him or her to take action to overturn asset protection arrangements. Apart from anything else, the trustee has in all likelihood similar arrangements in place, and so empathizes with the bankrupt. All that most registered trustees really want are jobs that earn them a decent fee without took much effort and with the likelihood of repeat referrals.

In the past in different forums I have argued that the best way of guarding against insolvency practitioners becoming too close to, and too supportive of, bankrupts, debtors and directors of failed companies is for their appointment to be made by the court on some sort of random or rotation system. I believe that this method of appointment of trustees should be introduced into the bankruptcy law. However, as this concept seems to be a lost cause in Australia I will not spend any more time on it.

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[4] *Principles of Bankruptcy in Australia*, E J Hayek, 2nd edition, Univ. of Qld Press (1967).

The recent bankruptcy of an insolvency practitioner (David Lockwood) has shocked many insolvency practitioners and reminded them of the perils they face and the potential risks to their own assets. I suspect that the proposed amendments are a bit too close to home.

Funding issues

A major obstacle to the successful operation of the proposed amendments to Division 4A will be the costs of taking action.

While the switch in the onus of proof in certain matters (described in paragraphs 47 to 50 of the explanatory memorandum) should help to contain costs, I think that serious consideration should be given to making funds available under Section 305 of the Bankruptcy Act specifically for use in action brought under Division 4A in those cases where there are insufficient monies in the estate.

Much has been said in the explanatory memorandum and elsewhere about the importance of the public interest. For this reason the Ministerial guidelines and conditions used in deciding on funding should be amended to reinstate "public interest" as a qualifying criterion.

In conclusion

All of the proposed legislation appears to me to be a considered and thorough attempt at addressing significant and demoralising weaknesses in the existing bankruptcy law. I congratulate those who contributed to it.

Yours faithfully,