

Bankruptcy move found wanting

Criticism is growing that rushed changes to bankruptcy procedures are fraught with danger for both parties, writes **Alex Bossell**.

Federal government reforms that could make bankruptcy more attractive to debtors and restrict lenders' ability to recover debts have been lashed by the major banks and insolvency practitioners, who question their justification and claim they are being rushed into law.

Among the more controversial changes are proposals to reduce the maximum period for bankruptcy for first-time bankrupts from three years to one year and raise the minimum debt for a creditor's petition — used to place a person into bankruptcy — from \$2000 to \$10,000.

The government is also considering whether the bankruptcy register should remain a permanent public record and if there should be a three-year period for pay contributions, which would oblige bankrupts with incomes above a statutory threshold to repay debts after the one-year bankruptcy period is over.

The chief executive of the Australian Bankers' Association, David Bell, says the changes have been designed to lessen the incidence of bankruptcy, but they may "have a completely opposite effect and are likely to result in an increase in bankruptcy numbers".

"Overseas experience suggests that changes to bankruptcy laws including a lessening of the significance of bankruptcy are likely to be a factor leading to increased bankruptcy numbers, not fewer," he says.

"Conversely, a tightening of access to bankruptcy in the US in 2005 saw a surge in debtor-initiated bankruptcies ahead of the commencement of the more restrictive regime."

He says that before any changes are made, "some well-defined research should be completed on the overseas experience and how Australia could be affected. This aligns with the government's best regulatory practice principles".

The Insolvency Practitioners Association of Australia, the Law Council of Australia, the Australian Bankers' Association and the Australian Finance Conference were given just two weeks to make submissions.

The proposals are not on the Attorney-General's department's or the Insolvency and Trustee Service Australia's websites, and were first reported in the *The Australian Financial Review* on June 2.

Responding to criticism that the consultation process has been inadequate, federal Attorney-General Robert McClelland says any changes to the bankruptcy system will be made in close consultation with key stakeholders.

"The aim of any changes would be to encourage those in financial difficulty to obtain advice and information about their options before entering bankruptcy," he says.

"The government is committed to ensuring the system is able to deal with personal insolvency issues quickly and efficiently so that people can get back on their feet as soon as possible."

Personal insolvencies increased by 12 per cent in the first half of this financial year compared with the previous one. There were 9300 in the March quarter, up from 7865 in the same period last year, and the figures for the June quarter are expected to be even higher.

Some argue the government is under pressure to reduce the resourcing burden on the personal insolvency regulator, ITSA, as the downturn drives up the number of bankruptcies. Raising the creditor's petition threshold to \$10,000 may ensure that fewer people are kept out of the bankruptcy system, but this may not necessarily ease the financial strain on the economy.

ITSA oversees more than 90 per cent of personal insolvencies, largely affecting consumer bankrupts with limited income and assets. Additional funding of \$14.3 million over two years was allocated in the budget to meet the rising demand on bankruptcy services.

The government and industry are divided over the impact of the proposed reforms.

Macquarie Research said in a briefing note

last week that the reforms came at the worst possible time and would create a hazard for Australian banks that could lead to higher loan impairment by consumers and small and medium-sized enterprises.

"We feel confident of a negative near-term outcome for the banks as any changes will accelerate the rate of consumer and SME delinquency and increase losses through the cycle due to moral hazard," the note said.

A spokeswoman for the Attorney-General's department says the proposals do not represent fundamental reforms but are "modest changes" reflecting that "people who make good decisions in good times, or take risks which benefit the economy, can be punished by the bankruptcy system if times go bad".

But critics say the reforms will make it harder for creditors to chase their debtors.

Australian Finance Conference associate director David Thorpe says financiers prefer a permanent public record of bankruptcy and some have reservations about the one-year bankruptcy period, which may "make it just a little too easy and not provide enough disincentive to keep away from bankruptcy".

Insolvency Practitioners Association of Australia president Mark Robinson says the one-year period could be appropriate for a majority of consumer bankrupts but not for "sophisticated bankrupts who were formerly captains of industry", the kind that have highly complex financial affairs and "residual wealth left over to pay high-priced lawyers".

Investigations can still be made after discharge but then trustees have lesser powers and it is harder to get public examinations, Robinson says.

The proposed three-year period for income contribution is little help when sophisticated bankrupts receive most of their income from large transactions, when "the main prize is clawing back fund transfers to related parties".

Law Council of Australia insolvency and reconstruction committee member Michael Lhuede says there is a concern "that the intent to shoehorn all cases on the basis that one description fits all can be problematic and is likely to be so in the future".

"If we bring it back to one year, we will encourage people to not attempt to find ways out of their difficulties," he says.

The reforms follow an internal review run by the AG's department. A discussion paper listing the proposals was released on May 28 to the department's key advisers in its Bankruptcy Reform Consultative Forum, after a draft was distributed in April.

Robinson says there has been "very limited and general consultation" and it appears the government has already made up its mind. After the forum received the draft in April, "the next thing we get is an email on May 29 saying, 'Look, the Attorney-General has decided that he wishes to proceed with these amendments in the near future and you better get your submissions in by June 12'," he says.

This was just two days after the AG's department's internal review was first made public in a Senate estimates committee hearing after questions from the opposition.

Thorpe says the speed at which the reforms are progressing is concerning. "They may have major ramifications. Let's give it a little more thought," he says.

Lhuede says such fundamental changes to the bankruptcy system should be made according to clear government policy after a review of the whole legislation, not individual parts of it, as has happened in the past. Otherwise there is a danger of continuing "this process of piecemeal change and what might be perceived as a knee-jerk reaction arising out of what are very tough financial times", he says.

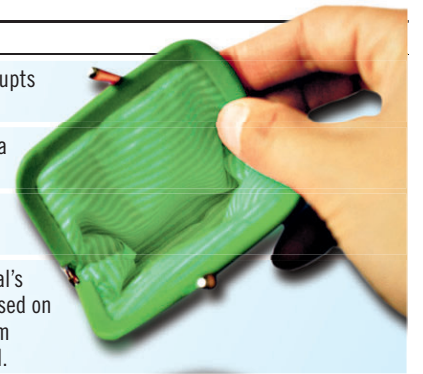
"This would effectuate a substantive change to bankruptcy law in Australia. I think we ought to be careful before we rush into that. There has yet been no public debate on it."

University of Melbourne law school associate dean Ian Ramsay says the government's consultation has been a "very

Reform or bust

Proposed changes to bankruptcy laws

- Reduce the maximum period for bankruptcy for first-time bankrupts from three years to one year.
- Raise the minimum debt for a creditor's petition, used to place a person into bankruptcy, from \$2000 to \$10,000.
- The government is also considering whether the bankruptcy register should remain a permanent public record.
- The reforms follow an internal review run by the Attorney-General's Department. A discussion paper listing the proposals was released on May 28 to the department's key advisers in its bankruptcy reform consultative forum after an earlier draft was distributed in April.



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- Federal Attorney-General Robert McClelland



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inferior and inadequate process" on a key issue of importance for the economy and society.

"It's a very disappointing discussion paper. Normally when government consults, you expect them to demonstrate that they have done some research. There is little demonstration of research here," Ramsay says.

"It is incumbent on the government to publish the research that it has done on the possible effects of these changes. Otherwise the changes are being released in a vacuum."

Lawyers also point to a number of shortcomings in the reform proposals.

James Conomos of James Conomos Lawyers says "the idea of a 12-month bankruptcy is just dumb".

"It would... create this artificial cover-up of what the true debt position of the country is without addressing the actual problem," he says.

Craddock Murray Neumann Lawyers

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BANKRUPTCY BARRISTER JAMES JOHNSON

partner Julian Van Leer says the threat of bankruptcy serves as an important means of enforcing debts.

"Everyone in the commercial community knows that the ultimate sanction you have to collect a debt is bankruptcy. Raising the limit to \$10,000 is going to make it much harder to collect debts," he says.

"In my experience, the best way to collect the debt is to go for the jugular — to go for bankruptcy first or winding up, as soon as you can in the process."

The Attorney-General's department spokeswoman says increasing the threshold "merely reflects the increased levels of indebtedness and the high costs of administering a bankruptcy where the debts are very low".

"This amendment will affect very few creditors; only around 2 per cent of creditor-initiated bankruptcies are based on a debt less than \$10,000," the spokeswoman says.

Bankruptcy barrister James Johnson says increasing the creditor's petition threshold to \$10,000 will encourage creditors who secure judgements against debtors to avoid a formal bankruptcy and use a sheriff to seize otherwise protected income or household furniture.

"I don't think anyone has really sat down and thought through the dynamics and the suffering of what I'll call 'the worker debtors'," he says.

Nicols + Brien insolvency trustee Steve Nicols agrees there is a danger that credit card and debt collection companies will have an extra incentive to send in the sheriff to seize property from the majority of honest consumer bankrupts that have lost their jobs, suffered business failure or are unable to extend a bank overdraft.

However, he says reducing the bankruptcy period to 12 months is a good idea as it motivates individuals, particularly entrepreneurs, to start earning income again.

"The creditors will see the benefit of that as well," Nicols says. "The creditors will be happy to know that these guys are out there making money and contributing."

Consumer Action Law Centre director, policy and campaigns, Nicole Rich, says consumer and community groups, including the peak body for financial counsellors, support the increase to \$10,000, as long as creditors are not allowed to exceed the threshold by waiting for interest to accrue on debts.

The IPA's Robinson says it will be better to cap the threshold at \$5000, indexed for inflation.