Insolvency Law
Bulletin

Centring debt justice in insolvency reform

Salman Shah *AUSTRALIAN LEGAL PRACTITIONER*

Introduction

Michael Murray and Dr Jason Harris in the July 2022 edition of the *Insolvency Law Bulletin* put forward a case for rebuilding the structure of the Australian insolvency system.[1] In their article, Murray and Harris draw attention to, among other things, *firstly*, the inefficiency of the current insolvency system, and *secondly*, the public function of insolvency administrations.

This contribution to the debate initiated by Murray and Harris elaborates on the two broad issues they raise, but from the perspective of debt justice. As I understand it, debt justice entails the redistribution of losses in a manner which balances the divergent interests of creditors, debtors and the public. As I discuss in the first section below, the current structure of the Australian insolvency system incentivises insolvency practitioners (**IPs**) to forego this balance in favour of maximising financial returns for themselves and, to the extent any surplus remains, for creditors.

In the second section, I argue that a just insolvency system (as distinct from a debt collection system) needs to treat debt justice as its raison d'être. This financial security function justifies a larger, central role for the Commonwealth in all insolvency administrations. In the third section, I advocate for a legislated set of policy priorities which give effect to debt justice considerations along with suggestions for the organisation and funding of a nationalised insolvency system.

Perverse incentives, perverse outcomes

The Australian insolvency system, like its English antecedents, operates on a flawed economic logic. It places responsibility for the proper administration of insolvent estates and companies which are definitionally unprofitable (or at least asset deficient) with private sector IPs (who are, as all actors in the private sector, profit-seeking). Proper administration requires that IPs carry out a number of important investigatory and administrative tasks which, as Murray and Harris observe, can become quite burdensome for the even the most asset deficient estates and companies.[2] As reimbursement of IPs' expenses in the administration is prioritised over payments to creditors or shareholders,[3] the more insolvent an entity is, the less creditors will expect to recover while any minimal recoveries will only stand to the IP's benefit.

This creates a perverse economic incentive whereby proper administration of the bankrupt estate or company can mean nothing more than maximising the IP's return whilst deriving no benefit for creditors — all at the expense of a debtor or company director.[4] Given that the majority of administered estates and companies are asset deficient, as Murray and Harris point out, IPs cross-subsidise asset deficient administrations by focusing their work on asset rich administrations. This inherently imbalanced economic structure and the speculative nature of private insolvency practice means that IPs charge high rates and are driven to maximise returns from any substantial asset which their investigations reveal (including by commencing litigation).

Of particular concern are personal insolvencies in which the only asset of substantial value is the family home. Increasing administration and litigation costs will eat up any equity in the home that may otherwise be available to creditors and discourage a search for arrangements that would allow the debtor to retain their family home.[5] In the case of corporate insolvencies, there is an incentive for liquidators to make claims against directors (such as claims of insolvent trading or unreasonable director-related transactions) to force a settlement of some sort (with the directors often selling their homes to meet these demands). There is no guarantee that any recovery will ever reach creditors.

Data from the Australian Financial Security Authority regarding personal insolvencies shows that only 16.84% of all estates finalised in 2021–22 paid a dividend and unsecured creditors recovered only 2.23% of their total claims in all finalised estates in in 2021–22.[6] These numbers simply beg the question: what was the quantum recovered in the 83.16% of estates which did not pay a dividend in 2021–22? Further, in the 16.84% of estates which paid a dividend, what is the ratio between the return to unsecured creditors and the return to the IPs themselves? As Murray and Harris correctly observe, there is simply insufficient data collected and collated regarding both personal and corporate insolvencies which explains the extent of the inefficiency.[7]

In my view, such inefficiencies cannot be avoided in a system where the financial interests of IPs are expected to co-exist with creditors' interest in a financial return and the debtor's interests in preserving their estate, especially in the context of asset deficiency. The most sensible method to increase the efficiency of the system would be to remove the IP's financial interest from the complex of interests which need to be satisfied. A range of options may be pursued, for example: (a) by implementing a system of fixed fees, commissions on successful recoveries and performance targets (**the rationalisation model**); or (b) by nationalising the insolvency system such that all insolvency administrations, both personal and corporate, default to being administered by the Commonwealth (**the nationalisation model**); or (c) some combination of the two.

Pursuing the rationalisation model will have the desired effect of increasing the efficiency of the insolvency system. In particular, a flat fee of, say, $10,000 per insolvency administration and an additional, say, 10% commission on recoveries may go a long way in ensuring that the financial interests of IPs are not at odds with interests of creditors.[8] Further, performance metrics and targets may be implemented and publicised — this could include, for example, reporting on "time spent per dollar returned" and stakeholder satisfaction rates.

However, due to the direct benefits to IPs, the interest which will likely take the place of IPs' financial interest is the creditors' interest in generating a return. This will be in tension with the debtor and public interests which the insolvency system also serves. I briefly discuss these debt justice considerations in the next section before turning to outline what a nationalised insolvency system could look like.

Debt justice, not debt collection

My thesis that the insolvency system serves a broader set of interests other than creditors' interests to recover debt is not in any way novel, even to Australia. For instance, there is longstanding judicial recognition of the fact that that IPs are to consider the interests of debtors as well as creditors and to exercise their powers for the public welfare.[9] As has been long recognised as the rule in *Ex parte James*,[10] the first and foremost duty of IPs is one of justice.[11] Nonetheless, it is worth briefly elaborating what I mean by debt justice in the insolvency context.[12]

Broadly, the purpose of the insolvency system is three-fold: *firstly*, it prevents the debtor's ongoing financial losses to swell into an economic crisis by the automatic stay and increased scrutiny of the debtor's affairs; *secondly*, it redistributes the debtor's losses fairly between the debtor, its creditors and the public. The law in this regard has a clear function of prioritising certain interests over others (incontrovertibly, this includes those of secured creditors and employees); *thirdly*, it creates the financial space to allow for the rehabilitation of the debtor. This is evident most clearly in the mechanisms for discharge of bankrupts and the opportunities for restructuring debts.[13]

These preventative, redistributive and rehabilitative functions are unique to the insolvency system and do not form a part of the debt collection system (comprising, for example, actions in debt, writs of execution and statutory demands) which governs the one-to-one relationship between a creditor and their debtor. Debt collection is aimed at dealing with debtors whose mischief is usually recalcitrance or fraudulence and it enables the creditor to be restored to the position they would be in if not for the mischief.

In contrast, the insolvency system does not deal with recalcitrance or fraudulence (at least not directly). It is instead intended to serve all situations where a restorative solution is precluded by the debtor's insolvency. In that respect, two features of insolvency distinguish it from recalcitrance or fraudulence: *firstly*, insolvency is not a mischief wilfully pursued by a debtor.[14] Instead, it is a state of affairs which the debtor would prefer to avoid but is unable to as a result of mismanagement or misfortune.[15] This "no fault" nature of insolvency is reflected in the requirement that a debtor is insolvent only when they are unable to pay their debts, rather than merely unwilling to;[16] and *secondly*, insolvency is often (though of course not always) indicative of broader economic currents more than individual ineptitude. This is especially true in an economic climate, such as today, that is subject to both inflationary and recessionary pressures and in which individual debtors' problems may result from national and global financial crises far beyond their comprehension and control.

Another feature distinguishes the insolvency system from the debt collection system. At the point of insolvency (unlike debt collection), a number of interests are at stake other than that of creditors. This includes the debtor's interest to minimise further losses and to move on with their lives or alternatively to continue their business. Family members of debtors and company directors have an interest in the financial stability of the debtor, and downstream businesses may have an interest in stable business continuity. More generally, there is a general public interest in the investigation and prosecution of wrongdoing by debtors and company directors.

These features in my view give rise to the need for the state's protective intervention to ensure that the debtor's financial crisis does not coalesce into an acute economic one. They require a solution which is collective and redistributive, rather than the relational and restorative logic of debt collection.

A just insolvency system

A nationalised insolvency system reimagined as a part of the Commonwealth's social and financial security system which is governed by a legislated set of policy priorities may give effect to debt justice considerations. In my view, the slate of policy priorities ought to include the following.

Firstly, a statement of the overarching purpose of the insolvency system. This purpose, as I outlined above, is three-fold and contains preventative, redistributive and rehabilitative aspects. The statement of purpose can be modelled upon the statement of the overarching purpose of civil practice and procedure provisions in section 37M of the Federal Court of Australia Act 1976 (Cth). Such a statement of purpose will ensure that there remains no misconception that the insolvency system is not merely another tool for creditors to collect debts.

Secondly, a list of the duties of insolvency administrators. This list ought to include requirements that insolvency administrators consider how the administration decisions will affect the balance of interests between the debtor, creditors and third parties. Currently, there are few legislated duties owed by bankruptcy trustees to bankrupts or by liquidators to directors or shareholders. Creditors appear as the chief beneficiaries of the insolvency system.[17]

Thirdly, a higher burden to pursue creditors and debtors for recoveries. Current recovery processes permit IPs to pursue creditors and directors to recover monies upon proof that the debtor was insolvent and that the creditor or director knew (or ought to have known) of the debtor's insolvency. Arguably, this disincentivises debtors from taking attempts to climb out of insolvency as any debts incurred or paid may later be clawed back by an IP. This may be remedied by placing a higher burden on insolvency administrators by, for example, requiring proof of an intent to defeat creditors or proof of dishonesty.

Fourthly, a single process for the commencement of both liquidation and restructuring. An insolvency system which takes its debtor rehabilitation goal seriously could have a single insolvency process which commences with a, say, 6 month debtor driven restructuring phase, failing which the insolvency administrator commences liquidation. Such a debtor driven process could apply even for administrations commenced by a creditor in a court. This could be paired with an expanded set of powers for insolvency administrators to return control of estates or companies to debtors,[18] for oversight of debtors, and for debt review, restructuring and cancellation. A flexible and unified insolvency approach could provide more opportunities for debtors to rehabilitate and return to the economy with minimal disruption to livelihoods and the economy.

Fifthly, procedures for review of the decisions of insolvency administrators. Current review processes permit those with "a financial interest" in the administration of an estate or company to apply to the court for an inquiry or directions.[19] While this process is suitable for most commercial company liquidations, it is likely to be out of reach for impecunious bankrupts and company directors given the formality of court processes and necessity for legal assistance. A quicker and cheaper review procedure, say, to a specialist insolvency tribunal or to the successor of the Administrative Appeals Tribunal may be apt.[20]

As for the institutional aspects of a nationalised insolvency system, my view is not dissimilar to Murray and Harris' who propose that the Commonwealth's role include certain essential regulatory, oversight and triaging functions. The office would not be limited to court appointed liquidations (such as in the United Kingdom) nor be the exclusive bankruptcy administrator (such as in New Zealand), but would have authority over both personal and corporate insolvencies and be able to enlist private sector IPs as necessary.

In my view, the funding for a nationalised model could be drawn partly from the public revenue and partly from a system of fixed fees chargeable to each administration with commissions on successful returns to creditors.[21] A fully funded public insolvency administrator will be best placed to administer what Murray and Harris refer to as "national interest insolvencies" (i.e., administrations with significant economic, social or environmental importance) and to investigate and prosecute wrongdoing by debtors and company directors where it is in the public interest to do so (notwithstanding that, or especially where, they will not give a financial return).

Conclusion

Murray and Harris opened this conversation with a focus on increasing the efficiency of the insolvency administrations with an eye on the public functions of the insolvency system. I have attempted here to refocus the conversation on what I term debt justice considerations and have suggested ways in which Australia's insolvency system may be realigned with its greater purposes.

Salman Shah
Australian Legal Practitioner
salmaaanshah@gmail.com

Footnotes

1. LLB (Hons), University of Tasmania; Australian Legal Practitioner
   Michael Murray and Dr Jason Harris, "Rebuilding the structure of the Australian insolvency system" (2022) *Insolvency Law Bulletin* 22 (1 and 2) 14–20.
2. Michael Murray, "Rethinking Insolvency Practitioner remuneration" (2022) *Insolvency Law Bulletin* 22 (3 & 4) 33.
3. Corporations Act 2001 (Cth) s 556 and Bankruptcy Act 1966 (Cth) s 109.
4. Throughout this article, I use the phrase company director to refer to the sole directors of (most usually) single shareholder companies which run small to medium businesses. Some common permutations also have spouses and parents or children as shareholders or are otherwise family owned. Some are structured as trading trusts.
5. An easy fix to this problem is to follow the long-standing precedent of the United States which exempts equity in family homes from bankruptcy assets. Although different states have varying degrees of protection, Texas and Florida have an unlimited exemption — meaning familial homes will never be at stake, even if they are of significantly high value far above creditor claims. A better approach would be to set a limit, say at the value of the price of the median house in the nearest metro area.
6. AFSA <www.afsa.gov.au/about-us/statistics/annual-administration-statistics/rate-return> Rate of return — bankruptcies; accessed on 18 January 2023.
7. This inefficiency is especially unjustifiable when viewed in light of some IPs' poor practices — as a number of inquiries have found. For example: Australian Small Business and Family Enterprise Ombudsman, *Insolvency Inquiry Report* (July 2020) pp 12–13; Australian Financial Security Authority, *Remuneration in the personal insolvency system* (March 2020) p 10; Australian Senate Economic Reference Committee, *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework* (September 2010) p 49–63.
8. The United Kingdom's Official Receiver operates on a model not dissimilar from this, however private IPs in the UK follow a different, more traditional remuneration model. An alternative option would be to place judicially administered limits on remuneration on a sliding scale as in the bankruptcy courts of the United States: 11 U.S. Code § 326.
9. *Adsett v Berlouis* [1992] FCA 549; 37 FCR 201; BC9203637 at [26]–[27] per Northrop, Wilcox and Cooper JJ.
10. *Ex parte James* [1874] LR 9 Ch 609.
11. For a recent exposition of the rule in *Ex Parte James* in the United Kingdom, see *Lehman Brothers Australia Limited (in liquidation) (scheme administrators appointed) v MacNamara and others* [2020] EWCA Civ 321 at [35]–[69].
12. Although there are many writers who espouse the view of the insolvency system which I hold, my views were most directly influenced by Elizabeth Warren. See, for example: Elizabeth Warren, "Bankruptcy Policy" (1987) *University of Chicago Law Review* Vol. 54:3 775. In general, the United States (in the context of which Warren writes) is considered to be more debtor friendly: Paul B Lewis. "Can't Pay Your Debts, Mate — A Comparison of the Australian and American Personal Bankruptcy Systems" *Bankruptcy Developments Journal* 18 (2001) 297. In relation to the relevance of community concerns in insolvency law, see: Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (1999, Yale University Press).
13. It could be argued that the insolvency system has two further purposes: *firstly*, a deterrent function to prevent bad debtor behaviour; and *secondly*, a macroeconomic function to reallocate unproductive assets, extinguish bad debts and "clean up" the economy. Both of these in my view are not substantive goals of the insolvency system but complimentary outcomes which the insolvency system supports.
14. Many a fraudster are attracted to the insolvency system as a deliberate means to defeat their creditors after having concealed their assets behind sophisticated corporate and trust structures. This in my view is properly characterised as a misuse of the system. In any case, the insolvency system has the necessary protective mechanisms to remedy such abuse. IPs are entrusted to investigate the affairs of bankrupts to identify fraud and recover assets for the benefit of creditors.
15. The insolvency system's current "no fault" approach represents a significant evolution from the beginnings of English bankruptcy law in the *Statute of Bankrupts* 34 & 35 Hen. 8, c. 4 (1542) which dealt with debtors who would today be described as recalcitrant or fraudulent, not insolvent. Given this evolution, it may be the case that the debt collection system requires a sequestration mechanism of its own to deal with fraudulence and recalcitrance (i.e., a mechanism distinct from the insolvency system which ought not to deal with these mischiefs).
16. Corporations Act 2001 (Cth) s 95A and Bankruptcy Act 1966 (Cth) s 5.
17. Creditors may give directions to IPs which they are bound to have regard to: Corporations Act 2001 (Cth) sch 2 cl 85-5 and Bankruptcy Act 1966 (Cth) sch 2 cl 85-5. Creditors may also remove IPs: Corporations Act 2001 (Cth) sch 2 cl 90-35 and Bankruptcy Act 1966 (Cth) sch 2 cl 90-35. No such powers vest in debtors.
18. Restructuring in Australia remains a complex mess with six debt restructuring processes across the bankruptcy and corporations legislation. While the power for company liquidators to return control to management does exist, it is not often used. Further, as one observer notes, Australian insolvency law incentivises the termination of businesses upon insolvency and disincentivises successful turnaround: Sewell & Kettle Lawyers, "What needs to be changed in Australian insolvency law: More carrots and less stick for directors" <https://sklawyers.

com.au/blog/what-is-the-purpose-of-our-insolvency-law-australia-needs-more-carrot-and-less-stick/>

19. Corporations Act 2001 (Cth) sch 2 cl 90-10 and Bankruptcy Act 1966 (Cth) sch 2 cl 90-10.
20. While there is a mechanism for review to the Inspector-General in Bankruptcy in relation to personal insolvencies, this is far from a general right to merits review which I am proposing.
21. This proposal in not unlike the financing model of the Official Receiver of the United Kingdom.