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Bankruptcy Legislation Amendment Bill 2004

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Nos. 125–126 2003–04

Bankruptcy Legislation Amendment Bill 2004

Bankruptcy (Estate Charges) Amendment Bill 2004

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Law and Bills Digest Group
10 May 2004

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Bankruptcy Legislation Amendment Bill 2004

Bankruptcy (Estate Charges) Amendment Bill 2004

Date Introduced: 24 March 2004

House: House of Representatives

Portfolio: Attorney-General

Commencement: The different parts of the two Bills commence on various dates as shown below.

Purpose

The purpose of these Bills is to make amendments to the operation of the personal insolvency provisions as contained within Part X of the *Bankruptcy Act 1966*. The Bankruptcy Legislation Amendment Bill 2004 also puts in place revised arrangements for the operation of Part IV Division 6 agreements.

Background

Arrangements other than bankruptcy

The Bankruptcy Act in Part IV Division 6, Part IX and Part X contains provisions that give debtors who cannot pay creditors' debts a way of discharging their debts as an alternative to entering into bankruptcy.

Part IV Division 6 compositions or schemes of arrangement

Part IV Division 6 provides that a person who has entered into bankruptcy can put together a proposal to pay for his or her creditors' debts (either in the form of a 'composition' or 'scheme of arrangement').¹ If the Part IV Division 6 composition or scheme of arrangement is accepted by the creditors, the bankruptcy is annulled once the terms of the arrangement have been satisfied by the debtor.

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Part IX Debt Agreements

Part IX of the Bankruptcy Act was introduced by the *Bankruptcy Legislation Amendment Act 1996* and is designed to provide low income debtors and their creditors with an informal and inexpensive alternative to bankruptcy. Under Part IX, a person who is unable to pay his or her debts can put together a proposal for a binding agreement with his or her creditors. The proposal sets out how the debtor intends to pay his or her debts. If the creditor agrees with the proposal and the debtor meets the terms of the agreement, the debtor is released from debts that would be provable in bankruptcy.

Part X Deeds of Assignment, Deeds of Arrangement and Compositions

Part X of the *Bankruptcy Act 1966* also operates as an alternative to bankruptcy. Part X agreements are normally entered into by high income earners and they take the form of an arrangement between a debtor and his or her creditors, so that a creditor's debts are satisfied without the debtor having to enter into bankruptcy.

Under Part X, a debtor who is unable to pay his or her debts appoints a controlling trustee and gives the controlling trustee control of his or her property. The debtor provides the controlling trustee with a statement of affairs (which sets out information relevant to the debtor's financial situation) and a Part X proposal (which sets out how the debtor intends to pay his or her creditors). The Part X proposal to creditors can take one of three forms, a deed of assignment, deed of arrangement or a composition. The distinctions between the three are fairly technical in nature.²

The controlling trustee must call a meeting of creditors to discuss the debtor's Part X proposal. The controlling trustee must prepare a report for the creditor's meeting that summarises and comments on the debtor's state of affairs and provides an opinion as to whether the creditors' interests would be better served by accepting a Part X proposal or by the bankruptcy of the debtor. The proposal to creditors is voted upon by the creditors at a formal meeting. If a majority of creditors accept the proposal it becomes binding on the debtor and all creditors in respect of their unsecured provable debts.

Once the creditors have agreed to the deed or composition, the creditors then cast a vote to appoint a trustee for the administration of the deed or composition. Part X administrations are usually administered by registered trustees, but may also be administered by the Official Trustee (through the Insolvency and Trustee Service Australia).

The debtor is released from the debts that would otherwise be provable in bankruptcy once the Part X arrangement has been completed.

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Operation of Part X of the *Bankruptcy Act 1966*

History

In September 2002 in a speech to the Insolvency Trustee Service Australia, the then Attorney-General Daryl Williams announced a review of Part X of the Bankruptcy Act. The review was conducted in response to concerns that Part X arrangements were being manipulated by debtors to avoid paying debts.³

Problems with the operation of Part X are not, in fact, a new occurrence. When the Australian Law Reform Commission (ALRC) conducted its ‘General Insolvency Inquiry’ which reported in 1988 it noted that:

Part X has been manipulated. For example, misleading or inadequate information has been given to creditors, meetings have been convened in obscure places, there has been insufficient notice given of meetings, meetings have been ‘stacked’ so that there are persons who exercise or purpose to exercise voting rights in favour of the debtor’s proposal and meetings have been conducted without an impartial chairperson.⁴

The ALRC did however make the point that:

The Commission does not consider that the recent abuses should be over magnified. The mischief was largely the fault of a few errant professionals (registered trustees and solicitors among them) who wrongly lent their positions and services at the behest of persons acting on the fringe of legality to produce arrangements or compositions under Part X that were, in most instances, patently bad and unlawfully concocted.⁵

Changes were made to the operation of Part X in 1987, which pre-empted a number of the ALRC’s recommendations and to an extent improved the operation of Part X of the Bankruptcy Act.

In 2002, Federal Parliament passed the *Bankruptcy Legislation Amendment Act 2002*. At the time the legislation was debated, the Australian Labor Party (ALP) argued that Part X of the Bankruptcy Act needed to be amended. In May 2002, in the House of Representatives, the ALP moved a series of amendments to the Act to address the deficiencies with Part X arrangements. In the course of the debate on Part X, the then Shadow Attorney-General Mr Robert McClelland stated the following in relation to Part X:

These provisions very much apply to those, I think is it fair to say, who are more at the big end of town – those who have had substantial assets. We are concerned that the proposals put forward by the government do not address the loopholes referred to in Part X of the Act, and indeed we note that there has also been some debate in the media about these provisions being abused or rorted.....We recognise that these provisions are important because, if properly used, they often result in debtors receiving more than they would have received if the person simply became a

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bankrupt. But ITSA itself has recognised that these provisions are generally used by higher-income earners and people in business who are able to offer their assets or payment from income to creditors.⁶

The ALP moved a series of amendments to the Bankruptcy Legislation Amendment Bill 2002 that sought to address problems with Part X of the Bankruptcy Act. Principally the amendments sought to address the following issues:

- related creditors, related controlling trustees and related trustees,
- the provision of accurate information to debtors, and
- running effective creditor meetings.

The amendments proposed by the ALP were not supported by the Government in the Senate and instead it undertook the review of Part X of the Bankruptcy Act.

Findings of the review

In October 2003 the Attorney-General the Hon Phillip Ruddock released the report on the review of Part X of the *Bankruptcy Act 1966*. In relation to the operation of Part X, the executive summary to the review stated the following:

Those participating in the review provided a broad range of frank and constructive feedback on the Part X system. There was general endorsement of the utility and performance of Part X by those providing submissions to the review. Some concerns were expressed regarding a number of problems in the industry. The review also identified a number of possible reforms to increase the effectiveness and efficiency of the system.⁷

One aspect of the review was its examination of the use being made of Part X agreements. The table below shows that the number of Part X administrations that have been entered into in the past ten years has steadily decreased in relation to the overall number of bankruptcy administrations.

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Number of Administrations per Financial Year⁸

	No. of Administrations			
	Part IV	Part X	Part IX	Total
1992/93	14852	792	0	15644
1993/94	14166	673	0	14839
1994/95	14132	539	0	14671
1995/96	17324	552	0	17876
1996/97	21846	439	47	22332
1997/98	24408	427	369	25204
1998/99	26378	492	480	27350
1999/00	23373	406	802	24581
2000/01	23902	409	1223	25534
2001/02	24114	313	3258	27685
2002/03*	11338	139	2471	13948

* The figures for 2002/03 are provisional only and relate to administrations commenced between 1 July 2002 and 31 December 2003.

The review noted that it was not possible, from the information available, to determine definitively which matters have contributed to the decline in Part X administrations. It did note that in submissions received, a number of common reasons put forward as contributing to the decline include:

- the creation of a new form of alternative arrangement to bankruptcy, Part IX Deeds of Arrangement
- the increased expense of implementing Part X agreements, and⁹
- a negative perception and lack of confidence in Part X agreements on the part of creditors.

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After noting the decline in the use of the Part X arrangements, the review went on to consider key aspects of the operation of Part X. The review identified a number of aspects of Part X that were not operating effectively. In particular the review noted that¹⁰:

- there was a lack of access by debtors, creditors and practitioners to sufficient information to make informed decisions and perform functions properly and adequately. For example there was a lack of disclosure of relevant information in reports to creditors, an insufficient understanding by both creditors and debtors as to the operation of Part X arrangements, and a lack of investigative powers for controlling trustees to obtain relevant information
- a small number of controlling trustees were not performing their tasks effectively. In particular there was a perceived lack of impartiality by a small minority of controlling trustees and concern as to the level of technical proficiency of some solicitors acting as controlling trustees
- activities that took place that denied the true general body of creditors the opportunity to determine whether to accept or reject a proposal. For example where there were ‘friendly’ or ‘related’ creditors. The report gave examples of where this may occur, such as:
 1. where a debtor could inappropriately influence the outcome of meetings by creating creditors prior to the meeting (for example, by arranging loans from friends or family members);
 2. the presence of existing friendly creditors who are genuine, and who are able to be influenced by the debtor for personal and not commercial reasons¹¹.....

The report also noted that the purchasing of creditors proxies could influence the outcome of creditors meetings:

The Issues Paper referred.....to a number of cases in which a creditor who effectively has the deciding vote being persuaded to sell their proxy to another creditor who supports this debtor’s proposal¹²

In relation to meetings, the report also noted that often ineffective notice was given to creditors regarding meetings

- there were complexities, costs and flaws in processes for termination, variation and avoidance of agreements and courts lacked power to vary flawed agreements, and
- there were other general issues such as the ability of controlling trustees to recover outstanding fees and outlays from debtors.

In response to the findings of the review the Government has proposed a series of amendments in the BLAB.

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Main Provisions

Bankruptcy Legislation Amendment Bill 2004

Schedule 1 – Amendments relating to statements of affairs and Part X agreements

Increasing the disclosure requirements of debtors, creditors and trustees involved in Part X arrangements

The Bill proposes that where the debtor has appointed a controlling trustee, that person is required to provide the debtor with information that is prescribed in the regulations. It is proposed that the regulations will state that the information to be disclosed to debtors is information relating to how Part X operates (**item 52**). The explanatory memorandum to the Bill states that:

this requirement will mirror that which applies to debtors wishing to petition for bankruptcy and is designed to ensure that debtors are informed about the Part X process and consequences from the start of that process.¹³

Item 53 of the Bill provides that the debtor's statement of affairs needs to be provided by the debtor to the person who is to be appointed as the controlling trustee before the controlling trustee's appointment becomes effective. This ensures that the controlling trustee has sufficient time to circulate the statement of affairs to creditors before the first creditors' meeting is called. The statement of the debtor's affairs is also to be made publicly available once a registered trustee has been appointed (**item 55**).

Item 65 proposes to amend the Act to provide that once the controlling trustee's appointment has become effective, he or she will have 25 working days within which to call a creditor's meeting (and if the approval was given in December, not more than 30 working days). This therefore gives controlling trustees more time than is currently available under the Act if public holidays fall during the time period for calling the creditor's meeting.

The Bill proposes to increase the disclosure requirements regarding the relationship between the debtor and creditors. As noted above (at page 2), controlling trustees are currently required to prepare a report for creditors stating whether the controlling trustee considers that the creditor's interests would be served by accepting the proposal or by the debtor going into bankruptcy. The Bill proposes to amend the Act so that the report must name all creditors identified as a related entity of the debtor in the debtor's statement of affairs (**item 58**). This will alert creditors to other creditors who are associates of the debtor and hence may influence the voting on a proposed agreement in a way that is most advantageous to the debtor.

The controlling trustee, appointed to establish Part X agreements, will also be required to make a written declaration stating whether the debtor is a related entity of the controlling

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trustee. This addresses the issue, noted above (at page 6), regarding the independence of controlling trustees.

In response to concerns regarding the aptitude of some controlling trustees (see page 5), the Bill proposes to amend the Bankruptcy Act to more clearly set out the duties and responsibilities of controlling trustees. Duties of the controlling trustee are currently set out in section 190 of the Bankruptcy Act. The Bill imposes an additional set of duties on the controlling trustee including the requirements to:

- exercise powers and perform functions in a commercially sound way
- exercise powers and perform functions in an independent manner, and
- refer to the Inspector-General or other relevant law enforcement agency any evidence of an offence by a debtor against the Act (**item 62**).

A regulation making power has been included in the Bill and regulations will be made to set out minimum performance standards for controlling trustees.

The Bill clarifies the law regarding a controlling trustee's entitlement to recover money owed by the debtor for performing the function of the controlling trustee. The Bill provides that a controlling trustee has a lien over the debtor's property and that he or she is entitled to be indemnified out of the debtor's property for a fee for being the controlling trustee and for costs, charges and expenses reasonably incurred by the controlling trustee (**item 58**).

In relation to trustees appointed to administer Part X arrangements, the Bill provides that prior to their appointment, trustees are required to declare whether the debtor is a related entity of the trustee or a related entity of the trustees (**item 126**).

Replacing the current three types of arrangements with a single form of arrangement to be called a personal insolvency agreement

Under the Bill, the three different forms of Part X agreement are removed and replaced with a single form of agreement known as a 'personal insolvency agreement'. The flexibility that the three types of agreements currently give users of Part X is maintained as a personal insolvency agreement is still able to take the form of an old deed of arrangement, deed of assignment etc. However replacing the three types of Part X agreements with one form simplifies the process for such arrangements.

Variation of the personal insolvency agreement

The Bill puts in place new arrangements for varying, setting aside and terminating Part X arrangements.

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Under the Bill, creditors and the trustee may vary the personal insolvency agreement where the debtor defaults of the terms of the agreement (**item 141**).

The Court may also set aside the personal insolvency agreement if the steps leading to putting in place the personal insolvency agreement are flawed. In particular, the Court may set aside the agreement where:

- The terms of the agreement are unreasonable or do not benefit creditors generally
- The agreement was not entered into in accordance with the requirements of Part X
- If the debtor has given false or misleading information or other inaccurate information
- The advice given by the controlling trustee in relation to whether the creditors' interests would be better served by accepting the Part X agreement versus sending the debtor into bankruptcy was incorrect
- Information regarding related party arrangements between the controlling trustee and the debtor was incorrect, or
- Information regarding related party arrangements between the trustee and the debtor was incorrect.

The Inspector General of Bankruptcy, the trustee or the creditors may apply to have the agreement set aside (**proposed section 222**). In limited circumstances, the debtor may also apply to have the agreement set aside (**proposed sub-section 222(2)**).

Having the agreement set aside is an act of bankruptcy and application may then be made to have the debtor put into bankruptcy.

Termination of the personal insolvency agreement takes place if there is a problem with carrying out the terms of the agreement. The trustee, creditors or the Court may terminate a personal insolvency agreement if one of the criteria as set out in **proposed sections 222A, 222B and 222C** are met, including the following:

- the trustee, creditors or the court may terminate a personal insolvency agreement if the debtor defaults on the agreement (**proposed sections 222A, 222B and 222C**)
- the creditors may terminate if the property of the debtor is covered by a restraining order or a forfeiture order or a pecuniary penalty order (**proposed section 222B**), and
- the court may terminate the agreement
- if it considers that the agreement cannot proceed without injustice or undue delay to creditors or debtors or where the debtor has died, the estate of the debtor or

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- for any other reason, if the court considers that the agreement ought to be terminated (**proposed section 222C**).

There will also be an automatic termination of an insolvency agreement if the personal insolvency agreement sets out triggers for the insolvency and one of those events occurs (**proposed section 222D**).

Where a Part X agreement has been set aside or terminated, all payments made, acts and things done and transactions entered into in good faith for the purposes of the agreement by the trustee or any other person up to receiving notice of termination of the agreement being set aside are valid (**item 224**).

The Bill also makes it clear that the debtor is released from ‘provable debts’,¹⁴ once the personal insolvency agreement has been executed (**proposed section 230**).

Commencement

Schedule 1 commences on proclamation or if proclamation takes place more than 6 months after Royal Assent, on the day after the 6 month period.

Schedule 2 - Amendments relating to Part IV Division 6 Compositions and Schemes of Arrangement

The explanatory memorandum to the Bill states that

Many of the concerns which will be addressed by the proposed amendments to Part X.....also arise in relation to post-bankruptcy compositions and arrangements. Therefore it is proposed to make some amendments to the provisions of Division 6 of Part IV to address these concerns.¹⁵

In particular the Bill will:

- require that the trustees report to creditors on the debtor’s proposal to name each creditor who was identified on the debtor’s statement of affairs as a related entity (**item 5**)
- require that the proposed trustee of the composition or scheme of arrangement make a written declaration stating whether the debtor is a related entity of the proposed trustee and whether the debtor is a related entity of a related entity of the proposed trustee (**item 6**), and
- insert new provisions in Part IV dealing with setting aside and termination of a composition or scheme of arrangement which draw on the proposed new provisions for Part X for setting aside and terminating a composition or scheme of arrangement (**item 8**).

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Commencement

Schedule 2 commences on proclamation or if proclamation takes place more than 6 months after Royal Assent, on the day after the 6 month period.

Bankruptcy (Estate Charges) Amendment Bill 2004

The Bankruptcy Estate Charges Amendment Bill makes consequential amendments to the *Bankruptcy (Estate Charges) Act 1997* to give effect to the changed arrangements under Part X of the Bankruptcy Act.

Commencement

The Bankruptcy Estate Charges Amendment Bill commences on proclamation or if proclamation takes place more than 6 months after Royal Assent, on the day after the 6 month period.

Concluding Comments

The Bills put in place arrangements to enhance the operation of Part X of the Bankruptcy Act. Some of the amendments were pre-empted by the ALP in 2002. At the time, the Government rejected the proposed amendments and instead initiated an inquiry into the operation of Part X. The amendments contained in these Bills are largely drawn from the findings of the inquiry.

The amendments will enhance the operation of Part X of the Act and to a lesser extent Part IV Division 6 and are not controversial in nature.

Endnotes

- 1 'Compositions' and 'schemes of arrangement' under Part IV Division 6 are similar in nature to compositions and schemes of arrangement under Part X of the Bankruptcy Act (see endnote 2).
- 2 'Deeds of arrangement' are an arrangement whereby the debtor arranges his or her business affairs in such a way as to pay off the creditors debts over a period of time. A 'deed of assignment' is where the debtor transfers all of his her property over to creditors and then becomes discharged of his or her debts. A 'composition' is a combination of a deed of arrangement and deed of assignment.

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- 3 The Hon Daryl Williams, '4th Biennial Insolvency Trustee Service Australia Bankruptcy Congress The Next Generation of Bankruptcy Law and Practice', *Speech*, Sydney, 20 September 2002.
- 4 The Law Reform Commission, *General Insolvency Inquiry Report No. 45*, vol. 1, Canberra, 1988, p. 205.
- 5 *ibid.*, p. 204.
- 6 Robert McClelland, 'Bankruptcy Legislation Amendment Bill 2002 Cognate Bill: Bankruptcy (Estate Charges) Amendment Bill 2002 Consideration in Detail', House of Representatives Debates, 30 April 2002.
- 7 Bankruptcy Review, Canberra, 2004 p. 1-2.
- 8 *ibid.*, p.10
- 9 *ibid.*, p. 21.
- 10 *ibid.*, p. 2.
- 11 *ibid.*, p. 55.
- 12 *ibid.*, p. 58.
- 13 *Explanatory Memorandum*, p. 12.
- 14 Provable debts are all debts and liabilities, present and future, certain or contingent, to which the bankrupt was subject at the date of the bankruptcy or to which the bankrupt may become subject before their discharge by reason of an obligation incurred before the date of the bankruptcy.
- 15 *Explanatory Memorandum*, p. 23.

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