MOVING BEYOND THE 'HARD'–'EASY' TUG OF WAR: A HISTORICAL, EMPIRICAL AND THEORETICAL ASSESSMENT OF BANKRUPTCY DISCHARGE

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[This article assesses the discharge period in consumer bankruptcy law — the period of time that a person remains in bankruptcy before being discharged. It does so from historical, empirical and theoretical perspectives. Its main thesis is that the recent abolition of early discharge was not soundly based and that early discharge should not have been abolished. It argues that the current discharge period should be shortened on the basis of a rational, structured policy approach. In doing so, it seeks to transcend the debate about whether bankruptcy law should be 'hard' or 'easy'.]

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I INTRODUCTION

Ask consumer debtors in most countries of the world why they filed for bankruptcy and they will say it was to get a 'fresh start'. Ask them when that will happen and there will be a variety of answers from 'a couple of months' from the English to 'ten years' from the South Africans; from 'it's up to the judge' from the Dutch to 'hopefully, before I die' from the Norwegians.[1] In Australia, the fresh start — as embodied by the discharge of a debtor's debts — occurs automatically, three years after a debtor files his or her statement of affairs. Why three years, asked Senator Gareth Evans of the then Attorney-General in 1980:

> What I ask the Minister is what principle, if any, has in fact guided the determination and settling upon the period of three years. Is it just the time honoured principle that any longer than that would be too long, and any shorter than that would be too short? In other words, does it have an intuitive quality about it, or is there something more rational?[2]

In response the Minister[3] offered a nod.[4] Despite Senator Evans' probing question, the recommendation of the Australian Law Reform Commission ('ALRC') recommendation of a shorter six month period[5] and the thousands of future bankrupts who would be affected, the issue was 'essentially a matter of judgment'.[6] The Attorney-General disclosed that the government wanted to significantly reduce the existing period of five years and that, according to the government, in most cases it took two years to distribute the debtor's assets to creditors.[7] Two years, however, was 'a little too short.'[8]

1 See generally Rafael Efrat, 'Global Trends in Personal Bankruptcy' (2002) 76 *American Bankruptcy Law Review* 81, 81–91.

2 Commonwealth, *Parliamentary Debates*, Senate, 25 March 1980, 999 (Gareth Evans).

3 Peter Durack, Attorney-General.

4 Commonwealth, *Parliamentary Debates*, Senate, 25 March 1980, 999 (Gareth Evans).

5 ALRC, *Insolvency: The Regular Payment of Debts*, Report No 6 (1977) [144].

6 Commonwealth, *Parliamentary Debates*, Senate, 27 March 1980, 1127 (Peter Durack, Attorney-General). See also Commonwealth, *Parliamentary Debates*, House of Representatives, 5 March 1980, 659 (Christopher Hurford); Commonwealth, *Parliamentary Debates*, Senate, 25 March 1980, 987 (Anthony Messner).

7 This claim directly contradicts an ALRC report published three years earlier, *Insolvency: The Regular Payment of Debts*, above n 5, where a six month period was considered 'ample for the administration of the estates of the vast majority of consumer debtors' because evidence indicated 'there is no property of any value in roughly 90 per cent of all cases': at [144] fn 30. See also below n 217 and accompanying text.

This was the extent of the parliamentary debate that preceded the enshrinement of the three year automatic discharge period in 1980. It would be more than 20 years before the issue was substantively debated. After flirting with an early discharge model between 1991 and 2002, Australia returned to a standard three year automatic discharge. Two years of stakeholder consultation,[9] a divided Senate inquiry[10] and a lengthy parliamentary debate culminated in the passing of the Bankruptcy Legislation Amendment Bill 2002 (Cth), but is Senator Evans' question any closer to being answered?

This article addresses the notable gap in existing literature regarding the period before discharge in bankruptcy. Its first objective is to analyse critically the Australian experience of early discharge between 1991 and 2002. This has not been previously examined in any depth. The second objective of this article is to assess discharge against certain theoretical approaches or policies. This approach has not previously been taken, either in the Australian context or elsewhere. The above parliamentary debate is characteristic of the lack of substantive consideration of discharge policy at the government level. Similarly, the discharge period, and even the significance of discharge itself, appears to have completely escaped the attention of the courts. Despite a voluminous literature on discharge's justifications, history, scope, availability and exemptions, the critical issue of how long a bankrupt should wait before receiving it has eluded scholarly attention.[11] The third objective of this article is to determine whether and how the discharge period can be reformed to comply with the devised policy approach.

These objectives are relevant both domestically and internationally. The length of the discharge period is not settled in Australia. When the Australian Labor Party reluctantly supported the 2002 amendment, it promised to monitor the impact of the change and revisit the issue when information became available.[12] Australia's unique experience also provides a useful comparative model for other countries. Australia's general approach to bankruptcy discharge puts it in the liberal camp, alongside countries such as the United States, the United Kingdom and many former British colonies.[13] Its reinstatement of a three year period came at a time when other countries were reducing their discharge periods. The United States' period stands at around four months,[14] Canada's at nine months,[15] and the

8 Commonwealth, *Parliamentary Debates*, Senate, 27 March 1980, 1127 (Peter Durack, Attorney-General).

9 The Bankruptcy Reform Consultative Forum was established in 1996 and is comprised of representatives from the finance industry, financial counselling services, banking sector, Commonwealth government, Australian Law Council and Insolvency Practitioners of Australia.

10 Senate Legal and Constitutional Legislation Committee, Parliament of Australia, *Inquiry into the Provisions of the Bankruptcy Legislation Amendment Bill and the Bankruptcy (Estate Charges) Amendment Bill 2001* (2001).

11 The likely reason is that the discharge period has not been an issue in the United States, where the vast majority of the theoretical literature has been generated.

12 Commonwealth, *Parliamentary Debates*, House of Representatives, 2 December 2002, 9315 (Robert McClelland, Shadow Attorney-General and Shadow Minister for Workplace Relations).

13 Efrat, 'Global Trends in Personal Bankruptcy', above n 1, 87–90.

14 *Bankruptcy Reform Act of 1978*, 11 USC § 727 (2004).

15 *Bankruptcy and Insolvency Act*, SC 1992, c 27, s 168.1(1)(f).

United Kingdom's between two and 12 months;[16] the European Commission has recently recommended early automatic discharge.[17] On the surface, at least, Australia is looking increasingly out of step. In addition, Australia is the only country to have substantially reduced and then increased its discharge period.

More generally, these objectives contribute to a broader debate that arises whenever bankruptcy is considered: put simply, whether bankruptcy should be 'hard' or 'easy'. Bankruptcy law may be conceptualised as the result of a game of tug of war between debtors and creditors. Debtors pull toward making bankruptcy easier and creditors pull in the opposite direction toward making bankruptcy harder, while Parliament acts as the referee. The playing field is often uneven. A well-resourced and organised credit industry is in a better lobbying position than the disparate group of debtor organisations.[18] In addition, politicians are loath to be seen as being lenient on high-flying debtors who abuse the bankruptcy process.[19] Other interest groups also play an important but seldom recognised role.[20] A recent summary of the history of bankruptcy law in England argues that this history is characterised by ad hoc decision-making, whereby Parliament has reacted and overreacted to problems or perceived abuses.[21] There has been no underlying policy; provisions seen as lenient to debtors were followed by harsher provisions to assuage creditors and vice versa.[22] This observation could equally be applied to bankruptcy law in many countries,[23] including Australia. The 2002 reforms to Australia's bankruptcy system, including the abolition of early discharge, were made to address concerns that the

16 *Insolvency Act 1986* (UK) c 45, s 279; see Iain Ramsay, 'Bankruptcy in Transition: The Case of England and Wales — The Neo-Liberal Cuckoo in the European Bankruptcy Nest?' in Johanna Niemi-Kiesiläinen, Iain Ramsay and William Whitford (eds), *Consumer Bankruptcy in Global Perspective* (2003) 205, 218.

17 European Commission, *Bankruptcy and a Fresh Start: Stigma on Failure and Legal Consequences of Bankruptcy* (2002) Europa 29 <http://europa.eu.int/comm/enterprise/entrepreneurship/support_measures/failure_bankruptcy/stigma_study/stigma_exec_summ.pdf>. See also European Commission, *Best Project on Restructuring, Bankruptcy and a Fresh Start: Final Report of the Expert Group* (September 2003) Europa 28 <http://europa.eu.int/comm/enterprise/entrepreneurship/support_measures/failure_bankruptcy/pdf_final_report/failure_final_en.pdf>.

18 In the United States context, see, eg, Robert Landry, 'The Policy and Forces behind Consumer Bankruptcy Reform: A Classic Battle over Problem Definition' (2003) 33 *University of Memphis Law Review* 509, 516–27.

19 See, eg, Attorney-General's Department, Australian Government, 'Tougher Laws to Stop Bankrupts Living the High Life' (Press Release, 14 May 2004) announcing the release of an exposure draft of legislation to discipline 'high income earners who use bankruptcy to avoid paying debts they can afford to pay.'

20 See Iain Ramsay, 'Interest Groups and the Politics of Consumer Bankruptcy Reform in Canada' (2003) 53 *University of Toronto Law Journal* 379.

21 Andrew Keay, 'Balancing Interests in Bankruptcy Law' (2001) 30 *Common Law World Review* 206, 225–6.

22 Ibid.

23 One of the key early texts on the history of bankruptcy in the United States, for example, is divided into 'the period of the creditor', 'the period of the debtor' and 'the period of national interest': Charles Warren, *Bankruptcy in United States History* (1935).

bankruptcy system was 'biased toward the debtor'[24] and made bankruptcy 'too easy'.[25]

This article analyses the discharge period in consumer bankruptcy from historical, empirical and theoretical perspectives. Part II reviews the fresh start policy — its context, importance, scope, qualifications and operation. Part III dissects and critiques Australia's policy towards early discharge. It argues that early discharge should not have been abolished and that both the specific and general arguments raised against it lacked evidence, were disputable or were not persuasive. Part IV considers certain theoretical approaches to bankruptcy and how these may be applied to the discharge period. It argues that bankruptcy laws, including the discharge period, should equitably balance the competing interests of debtors, creditors and the community. The relevant interests are identified and distilled into a rational, structured policy approach by which the discharge period should be evaluated. Part V takes this step, challenging the three year discharge period as failing to comply with such an approach. It posits instead that a short discharge period with certain eligibility criteria represents the most equitable balancing of the relevant interests. It argues for an end to the hard–easy tug of war and a commitment to a more sophisticated policy approach.

II The Fresh Start Policy in Australia

To understand the broader context within which the discharge period operates, this Part examines the fresh start policy.

A *Competing Objectives of Bankruptcy Law*

The fresh start policy, while important, is only one of a number of competing objectives of bankruptcy law. Bankruptcy can benefit debtors, creditors and the community as a whole.[26] Its two primary objectives are to ensure that the assets of the bankrupt are distributed fairly and equitably to creditors and to give the bankrupt a fresh start.[27] It also has a number of secondary objectives. Bankrupts are protected from the harassment of creditors seeking payment of debts. It ensures the investigation of the bankrupt's pre-bankruptcy conduct to reveal any improper, reckless or fraudulent dealings.[28] It protects creditors from bankrupts disposing of their property on the eve of bankruptcy. In addition, it benefits the general community. First, bankrupts are limited in the dealings in which they can engage. Second, rules against improper conduct maintain order and a higher

24 Explanatory Memorandum, Bankruptcy Legislation Amendment Bill 2002 (Cth) 2.

25 Commonwealth, *Parliamentary Debates*, House of Representatives, 21 March 2002, 1844 (Daryl Williams, Attorney-General).

26 Emil Hayek, *Principles of Bankruptcy in Australia* (2nd ed, 1967) 2. See also ALRC, *General Insolvency Inquiry*, Report No 45 (1988) [33].

27 *Storey v Lane* (1981) 147 CLR 549, 556 (Gibbs CJ); *Re McMaster; Ex parte McMaster* (1991) 33 FCR 70, 72–3 (Hill J); *Fitz-Gibbon v Inspector General in Bankruptcy* (2000) 180 ALR 475, 479 (Stone J). See also *R v Davison* (1954) 90 CLR 353, 375–6 (Fullagar J); *Hardy v Fothergill* (1888) 13 AC 351, 364, quoted in *Pyramid Building Society (in liq) v Terry* (1997) 189 CLR 176, 212 (Kirby J).

28 Andrew Keay and Michael Murray, *Insolvency: Personal and Corporate Law and Practice* (4th ed, 2002) 26.

degree of ethical conduct in commercial life. Third, credit transactions are facilitated, as creditors are more confident in lending, and persons requiring credit are not deterred from seeking it.[29] Against the background of these general objectives, this article focuses specifically on the discharge period — a part of the fresh start principle.

B *The Fresh Start Principle*

Bankruptcy law gives an over-indebted individual the opportunity to make a fresh start. The Australian approach to the fresh start policy has been characterised as 'reasonably generous to bankrupts',[30] but recent amendments, including the abolition of early discharge, have restricted its scope. The key element of the fresh start principle is discharge. Discharge functions as the 'escape door' for over-indebted individuals.[31] It operates to release the bankrupt from all provable debts.[32] It 'frees the debtor from the shackles of existing debt' and places them 'on the economic treadmill once again — to earn, consume and borrow'.[33] It is important to recognise that discharge is the principal point of the process, as most consumer bankruptcies produce little or no revenue for creditors.[34]

From a historical perspective, the relatively recent rise of discharge to primacy can be contrasted with the traditional view that bankruptcy was a punitive exercise designed to punish the deviant bankrupt.[35] As early as 1962, the Australian community 'accepted' that certain debtors should be released from their liabilities and given an opportunity to re-establish themselves with as little delay as possible.[36] The most recent inquiry into bankruptcy law in Australia reaffirmed that 'the end result of an insolvency administration, particularly as it affects individuals, should, with very limited exceptions, be the effective relief or release from the financial liabilities and obligations of the insolvent.'[37] However, the fresh start is neither instant nor absolute; there are a number of limited exceptions that serve to qualify the principle.

[29] See, eg, ibid 26–7. See generally Hayek, above n 26, 2.

[30] Rosalind Mason and John Duns, 'Developments in Consumer Bankruptcy in Australia' in Johanna Niemi-Kiesiläinen, Iain Ramsay and William Whitford (eds), *Consumer Bankruptcy in Global Perspective* (2003) 227, 234.

[31] Study Committee on Bankruptcy and Insolvency Legislation, Canada, *Bankruptcy and Insolvency: Report of the Study Committee on Bankruptcy and Insolvency Legislation* (1970) 86.

[32] *Bankruptcy Act 1966* (Cth) s 153(1). See below Part II(C)(3).

[33] Richard Flint, 'Bankruptcy Policy: Toward a Moral Justification for Financial Rehabilitation of the Consumer Debtor' (1991) 48 *Washington and Lee Law Review* 515, 515–16.

[34] See below Part III(E).

[35] Lynden Griggs, 'Bankruptcy Policy and the Decision of the High Court in *Pyramid Building Society (in liq) v Terry*' (1999) 1 *University of Notre Dame Australia Law Review* 57, 62; Margaret Howard, 'A Theory of Discharge in Consumer Bankruptcy' (1987) 48 *Ohio State Law Journal* 1047, 1052; Iain Ramsay, 'Models of Consumer Bankruptcy: Implications for Research and Policy' (1997) 20 *Journal of Consumer Policy* 269, 270–4.

[36] Commonwealth, *Report of the Committee Appointed by the Attorney-General of the Commonwealth to Review the Bankruptcy Law of the Commonwealth*, Parl Paper No 236 (1962) [7].

[37] ALRC, *General Insolvency Inquiry*, above n 26, [33].

C *Qualifications to the Fresh Start Principle*

One of the qualifications to the fresh start principle — the focus of this article — is the discharge period. A bankrupt must wait a certain period before discharge. The discharge period should not be considered in isolation, but in the context of a number of other qualifications.

1 *Impact on Property*

The most striking effect of bankruptcy is on the bankrupt's property. All of the bankrupt's divisible property vests in the trustee, as does any divisible property acquired during the bankruptcy ('after-acquired property').[38] The typical consumer bankrupt, however, has little property.[39] Moreover, divisible property does not include necessary household property, items used to earn income, means of transport, certain insurance policies, personal injury compensation money and property held on trust.[40] The trustee can also recover property the bankrupt transferred when bankruptcy was imminent[41] and undo certain sales, gifts or other dispositions of property that unfairly diminish the assets available for distribution.[42] A discharged bankrupt may acquire and retain property without fear of its being taken for distribution.

2 *Restrictions, Disqualifications and Prohibitions*

Bankruptcy law imposes serious restrictions, disqualifications and prohibitions on bankrupts. Some of these extend beyond discharge. Personally, a bankrupt faces social stigmatisation, embarrassment and loss of self-esteem. Bankruptcy prohibits certain employment possibilities, such as managing a corporation[43] or acting as a real estate agent,[44] and imposes restrictions on various others.[45] Bankrupts are restricted regarding overseas travel.[46] They also face a degree of public exposure and a severely tarnished credit record. First, creditors are notified of the bankruptcy.[47] Second, the bankruptcy is permanently recorded in the National Personal Insolvency Index, which is open for public inspection.[48] Third, bankruptcy is listed on commercial credit reference files for seven years, which credit providers use in assessing whether to lend money.[49] Fourth, a bankrupt must disclose their bankruptcy to anyone to whom they apply for credit

[38] *Bankruptcy Act 1966* (Cth) s 58(1). The trustee is either a registered trustee or the Official Trustee: see ss 156A, 160.

[39] See below Part III(E).

[40] *Bankruptcy Act 1966* (Cth) s 116(2).

[41] This is the doctrine of relation-back: *Bankruptcy Act 1966* (Cth) s 115.

[42] *Bankruptcy Act 1966* (Cth) ss 118–22.

[43] *Corporations Act 2001* (Cth) s 206B(3).

[44] See, eg, *Estate Agents Act 1980* (Vic) s 14(5)(d).

[45] See John Duns, *Insolvency Law and Policy* (2002) 175–6. See also Keay and Murray, above n 28, 72.

[46] *Bankruptcy Act 1966* (Cth) ss 77(a)(ii), 272.

[47] *Bankruptcy Act 1966* (Cth) s 19(1)(a).

[48] *Bankruptcy Regulations 1996* (Cth) regs 13.03, 13.06.

[49] See *Privacy Act 1988* (Cth) ss 18K–18L; Bruce Kercher, Richard Brading and Betty Weule, *Consumer Debt Recovery Law* (2[nd] ed, 2002) 151–2.

of approximately $4000 or more.[50] The practical effect of these restrictions is that undischarged bankrupts are unlikely to look for credit and are unlikely to receive it if they do. There are other practical consequences. A bankrupt may have difficulty in renting a house, for example, since bankruptcy is part of the public record that estate agents check.[51] Upon discharge, a bankrupt is restored to full legal capacity and most of the restrictions and prohibitions on commercial activity, such as incurring credit without disclosure of the bankruptcy, are removed.

3 *Non-Dischargeable Debts*

There are a number of exceptions to the general principle of discharge from debts. Even after the discharge, the bankrupt will still have to satisfy any liability under a maintenance agreement, fraudulently incurred debts, liability under a pecuniary penalty order, bail money debts, and Higher Education Charge Scheme liability, and will be liable to pay certain income acquired after bankruptcy.[52] A discharged bankrupt will also have to pay any non-provable debts, including: unliquidated damages not arising out of a contract, promise or breach of trust;[53] court-imposed criminal fines;[54] and interest on provable debts from the date of bankruptcy.[55]

4 *Income Contributions*

A bankrupt may also be liable to make income contributions.[56] The requirement to make contributions depends upon the debtor's level of income, number of dependants and payment of any child support.[57] On 20 September 2004, a debtor with no dependants would have to start paying contributions if he or she earned over $35 763 before tax.[58] Only a very small percentage of the total number of bankrupts are liable to contribute each year. In 2001, for example, it was approximately 2.4 per cent.[59] The provisions are aimed at the small number of high-flying bankrupts, rather than the typical consumer bankrupt.[60] Discharge frees the bankrupt from any liability to contribute from his or her income.

50 *Bankruptcy Act 1966* (Cth) ss 269, 304A.

51 Kercher, Brading and Weule, above n 49, 152.

52 *Bankruptcy Act 1966* (Cth) s 153(2); *Higher Education Funding Act 1988* (Cth) s 106YA.

53 *Bankruptcy Act 1966* (Cth) s 82(2).

54 *Bankruptcy Act 1966* (Cth) s 82(3).

55 *Bankruptcy Act 1966* (Cth) s 82(3B).

56 Total contributions collected during 2002–03, for example, were $6 960 358: Insolvency and Trustee Service Australia, Australian Government, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 2002–2003* (2003) 27 <http://www.itsa.gov.au/dir228/itsaweb.nsf/docindex/About Us->Publications->annual Documents/$FILE/I-G_Annual2003.pdf?OpenElement>.

57 *Bankruptcy Act 1966* (Cth) ss 139P, 139Q, 139S.

58 Insolvency Trustee Service Australia, Australian Government, *Trustees: Current Amounts* (2004) <http://www.itsa.gov.au>.

59 Mason and Duns, above n 30, 240.

60 Kercher, Brading and Weule, above n 49, 153–4. See below Part III(E) for a description of the typical consumer bankrupt.

5 *Delaying Discharge*

The discharge period may be extended if the trustee makes an objection. There are a number of grounds upon which an objection may be made. These include the bankrupt engaging in misleading conduct, failing to disclose assets or failing to disclose income.[61] If successful, the discharge period may be extended to five or eight years, depending on the ground of the objection.[62] While the number of objections lodged each year is very small,[63] the provision to delay discharge is an important tool for regulating commercial behaviour, ensuring the bankrupt's cooperation during bankruptcy and protecting the community.[64] In the absence of an objection, a bankrupt will be automatically discharged three years after they file a statement of affairs.[65]

D *Distinguishing between Bankrupts*

A recurring theme in bankruptcy law, and particularly in discharge policy, concerns distinguishing between different types of bankrupts. Three issues can be identified.[66] The first issue is whether any distinction should be made. Treating all bankrupts alike may have the advantage of simplicity, convenience and cost-effectiveness, but doing so ignores the significant differences between bankrupts. The second issue is which types of bankrupts should be distinguished from each other. To what extent, for example, should laws distinguish between bankrupts on the basis of conduct, income, assets or some combination of these elements? The third issue is how and when this distinction should be made. This article, for example, employs the common, but imperfect, distinction between consumer bankrupts (whose debts relate to the consumption of goods and services) and business bankrupts (whose debts relate to an interest in a business or company). While distinguishing between bankrupts may be useful, problems occur at the practical level. Generally, the closer a bankrupt is to the dividing line, the more difficult the distinction becomes to draw, and the greater the chance of discrimination and injustice.[67] While not the focus of this article, each of these three issues arises in the context of the discharge period.

Currently, a distinction is made between a bankrupt who has committed fraudulent conduct ('fraudulent bankrupt') and other bankrupts ('unfortunate bankrupt'). There are numerous practical problems in even this seemingly simple

61 *Bankruptcy Act 1966* (Cth) s 149D.
62 *Bankruptcy Act 1966* (Cth) s 149A.
63 In 2002–03, 310 were entered: Insolvency and Trustee Service Australia, above n 56, 34.
64 ALRC, *General Insolvency Inquiry*, above n 26, [340].
65 *Bankruptcy Act 1966* (Cth) s 149. A statement of affairs contains detailed information on the debtor's assets, liabilities and income: see s 6A; and see Insolvency and Trustee Service Australia, *Form 3* (2004) <http://www.itsa.gov.au/dir228/itsaweb.nsf/docindex/About Us->Publications->New Statutory Forms Document/$FILE/Form_03.pdf?OpenElement>. It is filed at the same time as a debtor presents his or her petition for bankruptcy: s 55(2)(b). If a creditor's petition is presented and a sequestration order made, it should be filed within 14 days after the debtor is notified of the bankruptcy: s 54(1).
66 See generally Keay, 'Balancing Interests in Bankruptcy Law', above n 21, 228–30.
67 Ibid.

distinction.[68] Nevertheless, Australian bankruptcy law distinguishes between these two types of bankrupts in the administrative and discharge processes.[69] An unfortunate bankrupt can expect a brief and non-intrusive administration and a standard discharge period of three years. By contrast, a fraudulent bankrupt can expect a rigorous administration designed to expose any commercially culpable conduct and is likely to have discharge delayed. In relation to early discharge, further complications arose over attempts to distinguish another type of debtor — one who incurred debt recklessly or negligently ('reckless bankrupt').

III Discharge in Australia

Just over ten years after the introduction of early discharge, the *Bankruptcy Legislation Amendment Act 2002* (Cth) abolished it.[70] From 5 May 2003, new bankrupts were no longer eligible to apply. Proponents raised a range of specific arguments for its abolition. In addition, their general argument was that early discharge made bankruptcy too 'easy'. Too much ground had been given to debtors, and bankruptcy needed to be made 'harder'. This Part argues that early discharge should not have been abolished and that the arguments raised against it lacked evidence, were disputable, or related merely to the operation of certain eligibility criteria. More generally, this Part exposes the inherent problems with the hard–easy tug of war approach and reveals the need for a more sophisticated alternative.

A *Brief History*

Under the *Bankruptcy Act 1924* (Cth), a bankrupt could be discharged only if he or she successfully applied to the court. The existence of the right was not well-known and 'relatively few' bankrupts applied.[71] The high cost of the proceedings, apprehensiveness about administrative complexities, fear of judicial proceedings and lack of motivation or initiative also limited resort to discharge.[72] Between 1924 and 1965, 'the legislation was directed more towards performing a regulatory and protective role than to restoring or rehabilitating bankrupts.'[73] This began to change with the introduction of the *Bankruptcy Act 1966* (Cth). Discharge would occur automatically after a period of five years.[74] If the creditors or the trustee objected, discharge could be extended indefinitely. A bankrupt also had the right to apply for an expedited discharge of sorts after he or she had been publicly examined. Only a small minority of (mainly business)

68 Ibid.

69 ALRC, *General Insolvency Inquiry*, above n 26, [282].

70 The Bankruptcy Amendment Bill 2001 (Cth) was substantially similar to the Bankruptcy Amendment Bill 2002 (Cth), but lapsed when a general election was called.

71 *Report of the Committee Appointed by the Attorney-General*, above n 36, [228].

72 ALRC, *General Insolvency Inquiry*, above n 26, [341].

73 Ibid [542].

74 No explanation was offered for the five year period: see *Report of the Committee Appointed by the Attorney-General*, above n 36, [233].

bankrupts did so.[75] In the 1974–75 financial year, for example, only 11 per cent of bankrupts took early discharge.[76] Discharge was further liberalised in 1980.[77] First, the discharge period was reduced to three years. As noted above, no substantive reason was offered for this period.[78] Second, grounds of objection were specified and operated to delay discharge rather than disqualify it. Third, a bankrupt could apply for a discretionary order of discharge after 12 months. In 1988, the ALRC recommended a form of early discharge for unfortunate bankrupts.[79] While two mechanisms for early discharge existed, they were rarely used because of the associated legal costs.[80] In 1990–91, for example, there were only 45 applications.[81]

B *The Introduction of Early Discharge*

1 *Aim*

Early discharge was introduced in the *Bankruptcy Amendment Act 1991* (Cth). It began operation in June 1992. The purpose of early discharge was 'to enhance the opportunities of persons with levels of debt that they have no prospect of repaying to begin the process of financial rehabilitation at an early date.'[82] A bankrupt could apply in writing to his or her trustee for early discharge at any time six months after he or she filed a statement of affairs.[83] If the trustee refused the application, a dissatisfied bankrupt could apply to the Administrative Appeals Tribunal or the Inspector-General for a review of the decision.[84]

2 *Criteria*

Early discharge was not open to all bankrupts; there were a number of eligibility and disqualification criteria. The main purpose of these criteria was to ensure that fraudulent and reckless bankrupts were disqualified.[85] The criteria also operated to ensure early discharge was confined to first-time bankrupts with little property and a low level of indebtedness relative to income.

75 This path was open even if an objection had been lodged: ALRC, *Insolvency: The Regular Payment of Debts*, above n 5, [123]–[124].
76 Ibid [124].
77 *Bankruptcy Amendment Act 1980* (Cth).
78 See above nn 2–6 and accompanying text.
79 ALRC, *General Insolvency Inquiry*, above n 26, [550], [554].
80 Commonwealth, *Parliamentary Debates*, Senate, 14 November 1991, 3127 (Bob McMullan); ALRC, *General Insolvency Inquiry*, above n 26, [545].
81 Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1990–1991*, Parl Paper No 275 (1991) 13.
82 Explanatory Memorandum, Bankruptcy Amendment Bill 1991 (Cth) 2.
83 *Bankruptcy Act 1966* (Cth) s 149S (repealed). See generally Division 3 of Part VII, repealed by *Bankruptcy Legislation Amendment Act 2002* (Cth) sch 1 item 127. Citations to the early discharge sections throughout the remainder of this Part refer to the *Bankruptcy Act 1966* (Cth) before this occurred — the Act with amendments up to the coming into force of the *Bankruptcy Legislation Amendment Act 2002* (Cth). The relevant sections have been summarised in Keay and Murray, above n 28, 158; Duns, above n 45, 405–6.
84 *Bankruptcy Act 1966* (Cth) ss 149ZM(a), 149ZH(1)(b) (both repealed).
85 Explanatory Memorandum, Bankruptcy Amendment Bill 1991 (Cth) 9.

An early discharge would be given only if the bankrupt

- had insufficient money to pay the remuneration and expenses of the trustee or a dividend to creditors;
- had not disposed of property in a transaction which was void against the trustee; and
- would not be liable to make income contributions within one year of the application.[86]

In addition, the bankrupt would be disqualified from early discharge if he or she

- had incurred unsecured debts exceeding 150 per cent of his or her income in the year preceding the date of bankruptcy ('150 per cent rule');
- had previously been bankrupt or entered into a Part X arrangement[87] within the past 10 years; or
- gave false or misleading information about his or her assets, liabilities or income.[88]

C *The Operation of Early Discharge: 1992–2003*

There is limited information available on the operation of early discharge. The key statistical data is represented in Table 1 and Figure 1 below.[89] After a large increase in bankruptcy filings between 1994 and 1997, numbers remained relatively stable. Numbers of early discharges averaged around 20 per cent of new bankruptcies, peaking at 32.8 per cent in 1999–2000.

86 *Bankruptcy Act 1966* (Cth) s 149T (repealed).

87 *Bankruptcy Act 1966* (Cth) pt X. A Part X arrangement, now known as a personal insolvency agreement, is an agreement between debtors and creditors whereby the debtor is able to satisfy his or her debt without entering into bankruptcy.

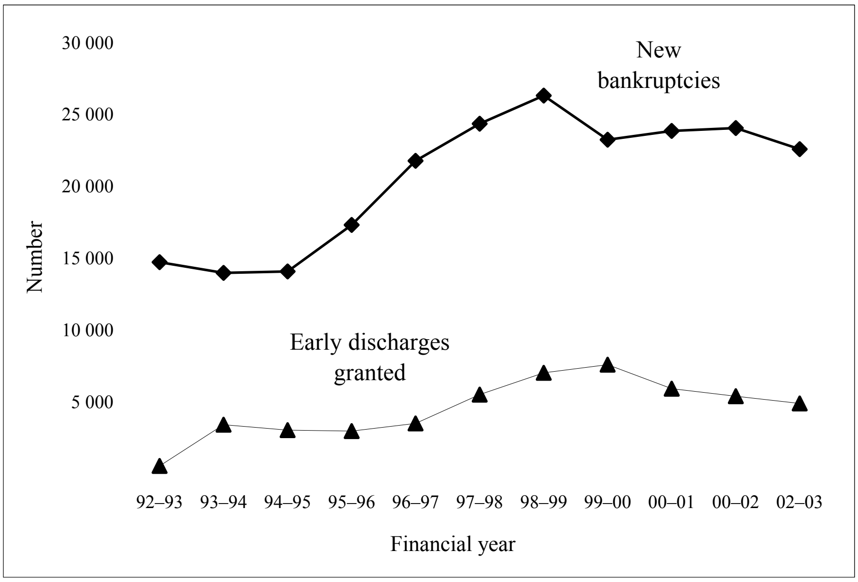
88 *Bankruptcy Act 1966* (Cth) div 3 sub-div D (repealed).

89 Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1992–1993*, Parl Paper No 250 (1993) 19, 24; Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1993–1994*, Parl Paper No 273 (1994) 19, 24; Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1994–1995*, Parl Paper No 440 (1995) 12, 18; Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1995–1996*, Parl Paper No 242 (1996) 11, 18; Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1996–1997*, Parl Paper No 352 (1997) 12, 18; Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1997–1998*, Parl Paper No 238 (1998) 10, 19; Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1998–1999*, Parl Paper No 433 (1999) 8, 27; Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1999–2000*, Parl Paper No 314 (2000) 7, 26; Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 2000–2001*, Parl Paper No 101 (2001) 5, 24; Commonwealth, *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 2001–2002*, Parl Paper No 519 (2002) 13, 25; *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 2002–2003*, above n 56, 13, 33.

Table 1: The Operation of Early Discharge 1992–2003

Financial Year	New Bankruptcies (Percentage Change from Previous Year)	Early Discharges Granted	New Bankrupts Granted Early Discharge (%)
1992–93	14 852 (–10.7%)	591	4.0
1993–94	14 166 (–4.6%)	3465	24.5
1994–95	14 132 (–0.2%)	3082	21.8
1995–96	17 324 (+22.6%)	3022	17.4
1996–97	21 830 (+26.0%)	3547	16.2
1997–98	24 408 (+11.8%)	5554	22.8
1998–99	26 376 (+8.1%)	7064	26.8
1999–2000	23 298 (–11.7%)	7641	32.8
2000–01	23 907 (+2.6%)	5964	24.9
2001–02	24 109 (+0.8%)	5442	22.6
2002–03	22 637 (–6.1%)	4939	21.8

Figure 1: Operation of Early Discharge



D *The Abolition of Early Discharge*

There were specific and general arguments raised against early discharge in 2002. This section outlines and challenges both.

1 *Critiquing the Specific Arguments*

First, detractors of early discharge submitted that it acted as a disincentive for debtors to consider alternatives to bankruptcy.[90] An individual in financial difficulties who is unable to pay his or her debts has a number of options apart from bankruptcy. Debtors can, of course, do nothing, but they then risk a creditor either using collection tools to take their essential property or filing a creditor's petition and forcing them into bankruptcy.[91] Informal arrangements include approaching creditors for relief or seeking financial help from various community or government organisations. A low income debtor with few assets and low levels of debt may propose a debt agreement under Part IX of the *Bankruptcy Act 1966* (Cth) if creditors agree to accept less than full payment.[92] Alternatively, a debtor may seek a personal insolvency agreement with his or her creditors under Part X.[93] In 2002–03, 22 637 people went bankrupt, 4550 people proposed agreements under Part X and 405 people proposed debt agreements.[94] Bankruptcy was thus the primary legal mechanism for dealing with individual insolvency. There was no statistical evidence to support the claim that early discharge provided a disincentive to considering these alternatives. Rather, the claim was merely based on the notion that a bankrupt would choose early discharge over entering a debt agreement or arrangement and having to pay back a portion of their debts.[95]

Second, some argued that six months was too short a period for debtors to become better financial managers.[96] This also appears to have been based on an unfounded notion. The data available contradicts this argument. At the end of the 2001–02 financial year, 3.3 per cent of bankrupts who had received an early discharge since 1 July 1992 had gone bankrupt again.[97] This compares favoura-

[90] Commonwealth, *Parliamentary Debates*, House of Representatives, 21 March 2002, 1844 (Daryl Williams, Attorney-General); Explanatory Memorandum, Bankruptcy Legislation Amendment Bill 2002 (Cth) 9.

[91] *Bankruptcy Act 1966* (Cth) ss 5(1), 43–4.

[92] *Bankruptcy Act 1966* (Cth) pt IX. See generally Keay and Murray, above n 28, 199–209.

[93] *Bankruptcy Act 1966* (Cth) pt X. See also *Bankruptcy Legislation Amendment Act 2004* (Cth). See generally Keay and Murray, above n 28, 167–98.

[94] *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 2002–2003*, above n 56, 11.

[95] Evidence to Senate Legal and Constitutional Legislation Committee, Parliament of Australia, Sydney, 19 July 2001, 2 (Donald Costello, Insolvency and Trustee Service Australia).

[96] Explanatory Memorandum, Bankruptcy Legislation Amendment Bill 2002 (Cth) 9.

[97] Submission to Senate Legal and Constitutional Legislation Committee, Parliament of Australia, *Inquiry into the Bankruptcy Legislation Amendment Bill 2001 and Bankruptcy (Estate Charges) Amendment Bill 2001* (2001) Attachment A, 3, Table 3 (Insolvency and Trustee Service Australia). Table 3 lists 1332 as the total number of later bankruptcies among bankrupts who received an early discharge after 1 July 1992. It should be noted that some of the figures in this table conflict with those listed in the Annual Reports. The reason for this conflict is unknown. These figures have been disregarded and those in the Annual Reports preferred.

bly with the 7.2 per cent of bankrupts who received a standard discharge and went bankrupt again during the same period.[98]

Third, opponents of early discharge suggested that there was no intrinsic reason why bankrupts able to make a distribution should be ineligible for early discharge.[99] The eligibility criterion implied that bankrupts with assets or income were reckless bankrupts who had committed a misdeed or were less worthy than other bankrupts. This argument questions one of the specific qualifications to early discharge. It is not an argument against early discharge as a system, but rather an argument against the particular eligibility requirements. As such, it seems misplaced at best. Further, because one aim of early discharge was to assist low income debtors, it is reasonable that debtors who could make a distribution were not eligible. Similarly, the argument ignores another of the objectives of early discharge, which was the reduction of administrative costs.[100] Bankrupts were ineligible if they could pay their trustee's costs. Cost savings were achieved because no file was opened and there was no need for a long period of monitoring.[101] Apart from a tenuous 'moral worthiness' argument, a distinction between debtors with and without assets can also be justified on the basis that the former are better able to cope with bankruptcy and therefore have less need for early discharge. Put shortly, it recognises the 'vast difference between large bankrupts and the small poor bankrupts.'[102]

Fourth, detractors of early discharge proved that the 150 per cent rule could operate in discriminatory ways. The purpose of the rule was to disqualify reckless debtors. The appropriateness of this disqualification was supported when early discharge was introduced and was not questioned in the abolition debate. The reasoning was that a debtor with debts far in excess of their income must have incurred these debts negligently or recklessly and that this type of debtor did not deserve the benefit of early discharge.[103] However, attempting to make the distinction between reckless and unfortunate bankrupts solely on the basis of a high debt to income ratio is extremely crude. While in most cases, the 150 per cent rule would have operated as intended to exclude reckless bankrupts, the existence of grey areas meant there was always potential for discrimination.[104] One perceived unfairness was that debts included non-dischargeable debts. This was unfair in the situation where a non-dischargeable debt pushed a debtor over the 150 per cent level.[105] In addition, the 150 per cent rule could also

[98] Ibid. The table lists 8945 as the total number of later bankruptcies among bankrupts who received a standard discharge after 1 July 1992 and 123 474 as the total number of standard discharges since 1 July 1992.

[99] Explanatory Memorandum, Bankruptcy Legislation Amendment Bill 2002 (Cth) 10.

[100] Betty Weule, 'Early Discharge — Is It Needed?' (1999) 9(3) *New Directions in Bankruptcy* 12, 13.

[101] Ibid. This argument is taken up further below: see below nn 208–11 and accompanying text.

[102] Submission to Senate Legal and Constitutional Legislation Committee, Parliament of Australia, *Inquiry into the Bankruptcy Legislation Amendment Bill 2001 and Bankruptcy (Estate Charges) Amendment Bill 2001* (2001) 2 (Chris Joyce, Wesley Community Legal Service).

[103] Commonwealth, *Parliamentary Debates*, Senate, 19 December 1991, 5163 (Sid Spindler), 5163 (Michael Tate, Minister for Justice and Community Affairs).

[104] Keay, 'Balancing Interests in Bankruptcy Law', above n 21, 228.

[105] Weule, above n 100, 12.

operate in a discriminatory fashion in joint debt situations. Where two people incurred joint debts, the person with a higher income may satisfy the 150 per cent rule while the other failed.[106] Another example was that small business bankrupts could easily be disqualified.[107] There were no statistics to substantiate the discriminatory operation argument. Nevertheless, the argument is a valid one. It is, however, directed more against the 150 per cent rule than early discharge itself.

Fifth, some suggested that since only about half of those eligible for early discharge actually applied, it was neither necessary nor wanted. In 1994–95, 5863 people were assessed as likely to be eligible for early discharge, but only 3082 applications were approved.[108] In July 2001, approximately 60 per cent of bankrupts were eligible for early discharge, but only between 22 per cent and 33 per cent were granted it in the previous four financial years.[109] A survey conducted at Credit Line Financial Counselling Services suggests that the main reasons bankrupts did not apply were that they 'wanted to do their full time', they would still be unable to get credit and early discharge made no real difference to them.[110] It is also submitted that ignorance of the right's existence and the fact that an application attracted costs played a part, as was the case with previous forms of early discharge. Nevertheless, at its peak, nearly a third of new bankrupts were taking advantage of it.[111] This was significantly higher than previous early discharge options.

Finally, there was some suggestion that early discharge was merely of psychological benefit to bankrupts.[112] That is, because a bankrupt's credit rating remained tarnished even when they were discharged early, no 'real advantage' existed.[113] Proponents of early discharge disputed this argument. One debtor organisation asserted that early discharge encouraged 'small debt low income bankrupts and their families to recover and get on with their lives.'[114] Another debtor organisation illustrated the point with this example:

> How is a single parent with a couple of young children, on social security benefits, who has had a car accident, going to manage her meagre income better if she remains an undischarged bankrupt for 3 years, rather than 6 months?[115]

106 See ibid.

107 Submission to Senate Committee, above n 97, 12 (Insolvency and Trustee Service Australia).

108 *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 1994–1995*, above n 89, 18. Unfortunately, figures on eligibility were not published in subsequent reports.

109 Submission to Senate Committee, above n 97, 14 (Insolvency and Trustee Service Australia).

110 Weule, above n 100, 12. Neither the extent of the survey nor its methodology is stated.

111 See above Table 1.

112 Senate Legal and Constitutional Legislation Committee, above n 10, [3.17].

113 Weule, above n 100, 12–13.

114 Submission to Senate Committee, above n 97, 2 (Chris Joyce, Wesley Community Legal Service).

115 Submission to Senate Legal and Constitutional Legislation Committee, Parliament of Australia, *Inquiry into the Bankruptcy Legislation Amendment Bill 2001 and Bankruptcy (Estate Charges) Amendment Bill 2001* (2001) 2 (Gary Sullivan, West Heidelberg Community Legal Service).

In addition, early discharge did mean that a bankrupt's credit reference files were cleared two and a half years earlier than if they had received a normal discharge.[116]

2 *Critiquing the General Argument*

The fundamental argument in favour of abolition was a more general one. The Bankruptcy Legislation Amendment Bill 2002 (Cth) was introduced to address concerns that bankruptcy was 'too easy' and to 'better balance the interests of debtors and creditors.'[117] Proponents of abolition claimed that debtors were using bankruptcy as a sword to defeat claims of creditors that they might in fact repay, rather than as a shield to be used as the last resort to seek relief.[118] The abolition of early discharge was part of a suite of measures introduced with this concern in mind. One government Senator recognised during the Senate Inquiry into the provisions of the Bill that the political or public policy 'nub' of the legislation was the concern that early discharge made bankruptcy 'too easy'.[119] According to the Explanatory Memorandum, 'many' people believed that low income consumer debtors went bankrupt 'due more to lack of financial responsibility than to misfortune.'[120] Bankruptcy law needed to be tugged in the other direction.

This claim was based entirely on anecdotal evidence of creditors, mainly small businesses, that it was too easy for people to walk away from their debts.[121] A number of witnesses and submissions to the Senate Inquiry noted the absence of statistical evidence,[122] as did the Committee's Report[123] and the subsequent parliamentary debate.[124] Anecdotes should not constitute the primary basis for radical changes to policy. Their reliability is difficult to establish, they rarely portray the 'average' case, and a policy response based on anecdotal evidence

[116] This is because the seven year period begins at discharge: see *Privacy Act 1998* (Cth) ss 18K–18L.

[117] Commonwealth, *Parliamentary Debates*, House of Representatives, 21 March 2002, 1844 (Daryl Williams, Attorney-General). See also Explanatory Memorandum, Bankruptcy Legislation Amendment Bill 2002 (Cth) 2.

[118] Commonwealth, *Parliamentary Debates*, House of Representatives, 7 June 2001, 27 509 (Daryl Williams, Attorney-General). The Attorney-General did not use the same language when the Bill was reintroduced in 2002.

[119] Evidence to Senate Committee, above n 95, 6 (Senator Brett Mason).

[120] Explanatory Memorandum, Bankruptcy Legislation Amendment Bill 2001 (Cth) 9. This claim was not included in the Explanatory Memorandum for the Bankruptcy Legislation Amendment Bill 2002 (Cth).

[121] Evidence to Senate Committee, above n 95, 6 (Donald Costello, Insolvency and Trustee Service Australia); Submission to Senate Committee, above n 97, 13 (Insolvency and Trustee Service Australia).

[122] Evidence to Senate Committee, above n 95, 3 (Donald Costello, Insolvency and Trustee Service Australia), 21 (Adrian Lovney, Credit Union Services Corporation (Australia) Ltd); Submission to Senate Committee, above n 115, 2 (Gary Sullivan, West Heidelberg Community Legal Service).

[123] Senate Legal and Constitutional Legislation Committee, above n 10, [4.5]. See also Labor Senators Minority Report: at 22.

[124] Commonwealth, *Parliamentary Debates*, House of Representatives, 30 August 2001, 30 655 (Robert McClelland, Shadow Attorney-General), 30 660 (Nicola Roxon).

risks being disproportionate because anecdotes are not 'generalisable'.[125] As there will always be dishonest people, some abuse of the bankruptcy system is inevitable.[126] As a matter of policy, the more prudent approach is to demand empirical evidence of systematic or substantial abuse, rather than occasional abuses at the margin, before bankruptcy law is fundamentally modified.[127]

The only relevant statistics demonstrated that there had indeed been a rise in the total number of bankruptcies since the introduction of early discharge. The key issue was whether the introduction of early discharge underpinned the increase, or whether it was brought about by other factors. The related, more general, issue is the extent to which debtors were abusing the bankruptcy system.

E *Abuse of Bankruptcy*

1 *Australian Evidence*

If bankruptcy were too easy, debtor abuse could take three forms. First, bankruptcy would be used over and over again. Second, individuals using bankruptcy would not be in significant financial difficulty and would be able to repay their debts. Third, individuals would run up large debts with the intention of going bankrupt and receiving discharge — in other words, there would be an increase in the number of reckless bankrupts. While Australian evidence is not conclusive on these three issues, some preliminary observations can be made.

Regarding the first form of abuse, of those who became bankrupt in 2001–02, a high proportion — 13 per cent — had been bankrupt before.[128] The issue is what type of bankrupt is repeating. The repeat rate, for example, could be significantly higher amongst high income debtors than low income debtors. The lower repeat rate amongst bankrupts who received early discharge noted above[129] suggests that this may be the case. Repeat bankrupts were disqualified from using early discharge,[130] which prevented abuse in this way.

Regarding the second form of abuse, the typical consumer bankrupt is in desperate financial condition in terms of income, assets and debt level. Of the 22 637 bankruptcies in 2002–03, 81.9 per cent were consumer bankruptcies. This proportion has increased from 70.5 per cent in 1988–89, but has remained relatively steady since 1997–98.[131] The total number of consumer bankruptcies increased by over 350 per cent between 1989 and 1999, but numbers have

125 Teresa Sullivan, Elizabeth Warren and Jay Westbrook, 'The Use of Empirical Data in Formulating Bankruptcy Policy' (1987) 50 *Law and Contemporary Problems* 195, 205–7.

126 Henry Sommer, 'Causes of the Consumer Bankruptcy Explosion: Debtor Abuse or Easy Credit?' (1998) 27 *Hofstra Law Review* 33, 42.

127 See Elizabeth Warren, 'The Bankruptcy Crisis' (1998) 73 *Indiana Law Journal* 1079, 1084–6. See generally Sullivan, Warren and Westbrook, 'The Use of Empirical Data in Formulating Bankruptcy Policy', above n 125.

128 Insolvency and Trustee Service Australia, *Profiles of Debtors 2002* (2002) 9 <http://www.itsa.gov.au/dir228/itsaweb.nsf/docindex/About Us->Publications->Debtor Profile document/$FILE/Profile_of_Debtors.pdf?OpenElement>.

129 See above nn 97–8 and accompanying text.

130 *Bankruptcy Act 1966* (Cth) s 149X(a) (repealed).

131 *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 2002–2003*, above n 56, 14.

remained relatively steady since then.[132] In 2002–03, 94 per cent of bankruptcies resulted from debtors voluntarily petitioning for their own bankruptcy,[133] while the remaining six per cent resulted from creditors pushing a debtor into bankruptcy.[134] The most recent information about bankrupts concerns those who became bankrupt in 2001–02.[135] In the 12 month period immediately before bankruptcy, 27 per cent had an income of less than $10 000, 61 per cent had an income of less than $20 000 and 81 per cent had an income less than $30 000.[136] The median income level was $15 000.[137] Household income was also low, with the median level at $19 200.[138] The poverty line income level for a single unemployed adult with no dependants during 2001 was $14 458, rising to $18 561 for a single parent with one dependent child.[139] With respect to assets, 90 per cent of these bankrupts had assets of less than $1000.[140] In terms of debt levels, 30 per cent of these bankrupts owed creditors less than $10 000, 54 per cent owed less than $20 000 and 80 per cent owed less than $50 000.[141] The mean amount owed was over two and a half times the average annual household income.[142] The median amount owed was $18 141.[143] In short, the 2001–02 data reveals that the typical Australian consumer bankrupt is close to poverty, owns few assets and owes creditors more than a year's salary. Contrary to the arguments of the government and creditors, there are not substantial numbers of debtors who are going bankrupt while able to repay their debts; they are going bankrupt because, quite simply, they are poor.

In relation to the third form of abuse, the causes of bankruptcy cited by bankrupts suggest that most are victims of a change in circumstances. There is, of course, an issue over the reliability of this evidence, given that it is in the interests of bankrupts to 'play down' the reasons for their impecuniosity. For consumer debtors who went bankrupt in 2001–02, the primary cause of bankruptcy was said by 39 per cent to be 'unemployment', 21 per cent to be 'excessive use of credit',[144] 17 per cent to be 'domestic discord' and 10 per cent to be

132 Ibid.

133 There are no income, asset or debt limits for bankruptcy. However, a debtor's petition may be rejected if the Official Trustee finds that the individual is able to pay his or her debts within a reasonable time, is unwilling to pay creditors or has recently been bankrupt: *Bankruptcy Act 1966* (Cth) s 55(3AA).

134 *Annual Report by the Inspector-General in Bankruptcy on the Operation of the Bankruptcy Act 2002–2003*, above n 56, 13.

135 Insolvency and Trustee Service Australia, *Profiles of Debtors 2002*, above n 128.

136 Ibid 11.

137 Ibid.

138 Ibid.

139 Ibid 22.

140 Ibid 14.

141 Ibid 12.

142 Ibid 11–12.

143 Ibid 12.

144 The meaning of this is unclear. The causes are self-attributed and are classified and categorised from information provided by the bankrupts themselves.

'ill health'.[145] Economic conditions were stated as the most common cause for business bankruptcies (40 per cent).[146]

There is no evidence to link rising bankruptcy rates with debtor abuse or even liberalisations in the law. The most detailed Australian study associated the rise in bankruptcy rates with levels of personal credit, interest rates and unemployment.[147] It noted that while reforms in bankruptcy legislation and changing societal values played a role, the nature of the relationship was difficult to establish.[148] The high level of consumer lending and lax controls in granting credit are more likely causes of the rise in bankruptcy rates.[149] In addition, the number of bankruptcies in 2002–03 was only marginally higher than the rate in 1996–97. Moreover, an individual who incurred a high level of debt with an intention to go bankrupt risked disqualification under the 150 per cent rule. To conclusively answer the abuse question, substantial studies on the macro and micro level would need to be undertaken. The only country where this has occurred is the United States.

2 *United States Evidence*

A recent United States bankruptcy reform Bill was largely premised on the need to counteract a growing trend of consumer abuse.[150] The claim that United States bankruptcy laws were too easy and were substantially abused sparked a series of sometimes conflicting empirical studies. There were two elements to the claim. First, abuse was evidenced by the recent trend of increasing numbers of bankruptcy petitions; for example, bankruptcies rose by 19.6 per cent in 1997.[151] Second, a large number of debtors could repay a substantial amount of their debts.

The United States is the 'land of the bankruptcy.'[152] Its bankruptcy laws are more generous than those of Australia. In particular, discharge is more easily available than in almost any other country.[153] A debtor can receive an automatic discharge and a fresh start in around four months.[154] On a per capita basis, the number of consumer bankruptcies in the United States is over three times that in

145 Insolvency and Trustee Service Australia, *Profiles of Debtors 2002*, above n 128, 9.
146 Ibid.
147 Jaynendra Kumar, Rosalind Mason and Deborah Ralston, 'Consumer Bankruptcies: Causes and Implications for the Credit Industry' (1998) 17 *Economic Papers* 18, 26–7.
148 Ibid.
149 See Johanna Niemi-Kiesiläinen, Iain Ramsay and William Whitford, 'Introduction' in Johanna Niemi-Kiesiläinen, Iain Ramsay and William Whitford (eds), *Consumer Bankruptcy in Global Perspective* (2003) 1, 2–4.
150 See Zachary Price, 'The Bankruptcy Abuse Prevention and Consumer Protection Act' (2002) 39 *Harvard Journal on Legislation* 237.
151 Kumar, Mason and Ralston, above n 147, 21.
152 Teresa Sullivan, Elizabeth Warren and Jay Westbrook, 'Consumer Bankruptcy in the United States: A Study of Alleged Abuse and of Local Legal Culture' (1997) 20 *Journal of Consumer Policy* 223, 223.
153 Niemi-Kiesiläinen, Ramsay and Whitford, 'Introduction', above n 149, 12.
154 Sullivan, Warren and Westbrook, 'Consumer Bankruptcy in the United States', above n 152, 226.

Australia.[155] If there is any country where substantial abuse of bankruptcy is likely, it is the United States.

While the studies conflicted, the dominant view that emerged was that there was no evidence of substantial abuse. A few studies demonstrated that debtors were in a position to repay a portion of their debts and were abusing the bankruptcy system.[156] Other studies linked the increase in filings to abuse of the bankruptcy system.[157] However, the findings, independence and credibility of these studies have been seriously questioned.[158] The better financed, more independent, mainstream empirical studies suggested that most bankrupts were in desperate financial condition and could not repay significant sums to their creditors.[159] One comprehensive longitudinal study, for example, concluded that 'the great majority of debtors in bankruptcy are overwhelmed by debt they could not possibly pay'[160] and that the claim that bankruptcy law was too easy 'flies in the face of known facts.'[161] Abuse was neither widespread nor substantial. While the United States situation and the findings of these comprehensive studies cannot be directly translated to Australian circumstances, they do suggest that the problem of abuse in Australia is probably minimal, or at least overstated.

F *Evaluating Early Discharge*

The aim of early discharge was to enhance the ability of low income debtors with small debts to begin financial rehabilitation earlier. Evidence suggests that this aim was achieved. Those in favour of change failed to make the case for abolition, despite winning the removal of early discharge. The specific arguments lacked evidence, were disputable or concerned the operation of particular eligibility or disqualification criteria. More importantly, the fundamental argument against early discharge — that it made bankruptcy too easy — was based on weak anecdotal evidence from interested creditors. The available evidence in Australia and the United States suggests that the claim lacks foundation. The problem of abuse appears minimal. Further, the eligibility and disqualification criteria operate to address this problem. The typical Australian bankrupt is on a low income, has few assets and a high level of debt, and has gone bankrupt after a change in circumstances.[162] While some of the criteria may not have been finely tuned, early discharge clearly enhanced the opportunities of around 60 per cent of all bankrupts.[163]

155 Niemi-Kiesiläinen, Ramsay and Whitford, 'Introduction', above n 149, 12.

156 See Warren, 'The Bankruptcy Crisis', above n 127, 1084–1101; Rafael Efrat, 'Attribution Theory Bias and the Perception of Abuse in Consumer Bankruptcy' (2003) 10 *Georgetown Journal on Poverty Law and Policy* 205, 207.

157 See Efrat, 'Attribution Theory Bias and the Perception of Abuse in Consumer Bankruptcy', above n 156, 206.

158 Ibid 207.

159 Ibid 207–8.

160 Teresa Sullivan, Elizabeth Warren and Jay Westbrook, *The Fragile Middle Class: Americans in Debt* (2000) 239. See also Warren, 'The Bankruptcy Crisis', above n 127, 1100–1.

161 Sullivan, Warren and Westbrook, *The Fragile Middle Class*, above n 160, 238–9.

162 See above Part III(E)(1).

163 See above nn 109, 111 and accompanying text.

The primacy given to the specific and general arguments are a natural consequence of the superficial 'tug of war' approach to the issue. Basically, early discharge was seen as too debtor-friendly. The abolition of early discharge was debated in an ad hoc manner, with an overriding focus on anecdotal evidence suggesting abuse and the possible discriminatory operation of particular criteria. There was no consideration of the purpose or optimal length of the discharge period. A more sophisticated approach is needed that can take account of these issues. The challenge then is to construct an approach that can be used to evaluate a specific aspect of bankruptcy law such as the discharge period. Part IV takes up this challenge.

IV Towards a Rational Structured Policy Approach

This Part assesses bankruptcy and bankruptcy discharge from normative and theoretical perspectives. The first step is to establish a set of norms that bankruptcy laws should facilitate. Part IV(A) considers the two dominant normative approaches to bankruptcy law, termed the 'economic approach' and the 'balanced approach'. It argues that the balanced approach, according to which a law should equitably balance the interests of debtors, creditors and the community, is most appropriate and can be extended to a specific law such as the discharge period if both general and particular interests are identified. Part IV(B) adapts and applies certain theories of bankruptcy discharge to identify and explore these two levels of interests before considering whether they justify a long or short discharge period. Finally, Part IV(C) distils a rational, structured policy approach that can be applied to the discharge period.

A *Examining Normative Approaches to Bankruptcy Law*

1 *The Economic Approach*

An economic approach has dominated theoretical scholarship on bankruptcy law since the mid-1980s. The approach's central principle is that the bankruptcy system is merely a mechanism for collecting debt and maximising creditor returns. It began with the work of Thomas Jackson.[164] According to Jackson, bankruptcy law responds to a 'common pool problem' — the problem of how best to deal with a group of creditors all claiming from the bankrupt's limited pool of assets.[165] Bankruptcy law 'provides a way to override the creditors' pursuit of their own remedies and to make them work together.'[166] Thus, the primary rationale of bankruptcy law should be to maximise the value of a pool of assets for creditors.[167] Optimal bankruptcy laws should represent a creditors'

164 Thomas Jackson, *The Logic and Limits of Bankruptcy Law* (1986). See also Douglas Baird and Thomas Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors Interests in Bankruptcy' (1984) 51 *University of Chicago Law Review* 97.

165 Jackson, *The Logic and Limits of Bankruptcy Law*, above n 164, 10–12. Jackson extended his ideas in Thomas Jackson and Robert Scott, 'On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain' (1989) 75 *Virginia Law Review* 155.

166 Jackson, *The Logic and Limits of Bankruptcy Law*, above n 164, 17.

167 Ibid 24.

bargain, mirroring the agreement that creditors could be expected to have negotiated with each other before extending credit. While Jackson's work is extremely influential, there have been many critics of it.[168] The primary issue in the subsequent long-running debate is whether bankruptcy exists solely to maximise returns for creditors, or whether it should take account of a broader range of social and economic concerns.[169] From an Australian perspective, it is important to recognise that this debate is largely taking place with regard to corporate insolvency.[170]

2 *The Balanced Approach*

The competing approach stresses that the bankruptcy system must equitably balance the interests of creditors, debtors and the community. Steven Harris, for example, argues that '[b]ankruptcy law in large measure seeks to accommodate [the competing interests of debtors and creditors and] a number of societal values at the time when the debtor is in financial difficulty.'[171] Karen Gross is the main modern proponent of this approach in the field of consumer bankruptcy law.[172] Gross takes up what she calls the 'prescriptive challenge': the question of what bankruptcy ought to be in society.[173] The starting point for her analysis is that the broad impact of bankruptcy necessitates an approach with the capacity to take the interests of all the affected participants into account.[174] These affected participants clearly include debtors and creditors, whose interests are 'intertwined and frequently competing.'[175] Decisions based solely on creditor interests, for example, may affect debtors in positive and negative ways.[176] A consideration of debtor and creditor interests alone is insufficient, because bankruptcy also impacts on communities that have a 'substantial nexus' to the debtor.[177] Considering this third perspective is vital because community interests may be different from the interests of debtors and creditors.[178]

[168] See, eg, Donald Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (1990) 91 *Columbia Law Review* 717, 722–40; David Carlson, 'Philosophy in Bankruptcy' (1987) 85 *Michigan Law Review* 1341; Elizabeth Warren, 'Bankruptcy Policymaking in an Imperfect World' (1993) 92 *Michigan Law Review* 336, 336–7.

[169] Lawrence Ponoroff and F Stephen Knippenberg, 'The Immovable Object versus the Irresistible Force: Rethinking the Relationship between Secured Credit and Bankruptcy Policy' (1997) 95 *Michigan Law Review* 2234, 2294–5; Richard Butler and Scott Gilpatric, 'A Re-Examination of the Purposes and Goals of Bankruptcy' (1994) 2 *American Bankruptcy Institute Law Review* 269, 277. A good summary of the debate is Christopher Frost, 'Bankruptcy Redistributive Policies and the Limits of Judicial Process' (1995) 74 *North Carolina Law Review* 75.

[170] In the United States, 'bankruptcy' also refers to corporate insolvency rather than consumer bankruptcy: David Skeel, *Debt's Dominion: A History of Bankruptcy Law in America* (2001) 200.

[171] Steven Harris, 'A Reply to Theodore Eisenberg's *Bankruptcy Law in Perspective*' (1982) 30 *UCLA Law Review* 327, 364.

[172] Gross also considers corporate insolvency: Karen Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (1997). See also Keay, 'Balancing Interests in Bankruptcy Law', above n 21, 208–21.

[173] Gross, above n 172, 2.

[174] Ibid 15.

[175] Ibid 17.

[176] Ibid.

[177] See generally ibid pt IV.

[178] Ibid 22.

Under this approach, bankruptcy law can be conceptualised as the seat of a three-legged stool.[179] Each leg represents a group of interests — those of debtors, creditors and the community. The support of all three legs is crucial, and all are interconnected. Similarly, an ideal bankruptcy system will equitably balance all three interests: '[t]he debtor would have a fresh start, creditors would be paid in an economically efficient manner, and community interests would be preserved'.[180] Outcomes are not mandated; this is merely a methodological approach.[181] The final outcome or balance will represent Parliament's judgement as to how the interests should be balanced.[182]

While the goal is to achieve a perfect balance whereby all interests are satisfied, this can probably never be achieved because the interests involved are competing, constantly changing and never homogenous.[183] Nevertheless, the balance should be as equitable as possible. Once the relevant interests have been identified, the balanced approach is a powerful normative tool. The extent to which the bankruptcy system balances the competing interests can be used to determine its propriety. Likewise, any law reform should weigh the competing interests equitably.

3 *The Most Appropriate Approach*

A full assessment of the economic approach is well beyond the scope of this article, but some brief observations can be made. Donald Korobkin summarises its fundamental problem: in '[n]arrowly seeking to explain bankruptcy law as a mechanism for achieving economic outcomes, the economic account has prevented itself from locating what truly makes bankruptcy law distinct.'[184] Most importantly, because of its focus on corporate insolvency, the economic approach does not properly address the discharge provisions and the accompanying 'fresh start'.[185] A normative approach to bankruptcy should be able to explain all its parts and dimensions. Arguably, the economic approach does not do this. It is wholly concerned with what it sees as the 'distinct function' of bankruptcy law — the economic problem of collecting debt. While important, this is only one part of the bankruptcy system. The unique concern of consumer bankruptcy with a fresh start for the bankrupt justifies a normative approach that takes a broader range of interests into account. The balanced approach is superior in this respect. It allows sufficient generality and flexibility, and acknowledges the complexity of the issues.[186] The following part of this article seeks to build on this approach.

4 *Extending the Balanced Approach*

The balanced approach can be taken a step further and applied to specific parts of the bankruptcy system, such as the discharge period. Each part should also

179 Gross refers to this analogy, but does not develop it further: ibid 24.
180 Ibid 235.
181 Ibid.
182 See ibid.
183 Keay, 'Balancing Interests in Bankruptcy Law', above n 21, 235.
184 Korobkin, above n 168, 739.
185 Ibid 724. Specific economic theories on discharge are considered in below Part IV(B).
186 See Gross, above n 172, 24.

equitably balance the relevant competing interests of the debtor, creditor and community. There is a subtle but important difference. To return to the three-legged stool analogy, the focus now shifts to a particular part of the seat. The overall balance is vital, but the support of particular legs becomes more important the further away the part is from the seat's centre-point. Similarly, certain interests are more relevant to some parts of the bankruptcy system than others. Thus, of debtors, creditors and the community, one group may have a particular interest in a certain law. Part IV(B) below, for example, argues that the particular interests relevant to the discharge period are primarily those of debtors and the community. This does not necessarily mean, however, that the general interests of debtors, creditors and the community are unimportant. If certain parts overemphasise relevant particular interests, the overall balance in the bankruptcy system may be lost. It is submitted that the optimal discharge period will represent an equitable balance of both general and particular interests.

B *Identifying and Exploring the Relevant Interests*

1 *General Interests*

The starting point is to identify the general interests of creditors, debtors and the community in the bankruptcy system. These have been outlined above.[187] As Douglass Boshkoff succinctly states:

> Any bankruptcy law must, of necessity, be an accommodation between competing interests that include the creditor's desire to be paid, the debtor's desire to escape a burdensome situation, the value society places on having people pay their debts in full, and the value society places on allowing debtors to start anew when overtaken by financial misfortune.[188]

This includes the discharge period.

Another general community and creditor interest highly relevant to the discharge period is that the bankruptcy system should not be abused. Part III argued that concern over possible abuse underlay the abolition of early discharge in Australia. Abuse would 'detract from the institution of bankruptcy and unfairly deprive creditors of what they are owed.'[189] The general 'moral hazard' problem concerning discharge is that if it is too readily available, there will not be sufficient incentive for debtors to avoid over-indebtedness.[190] A similar argument against shortening the discharge period is that it will affect the deterrent aspect of bankruptcy and reduce a debtor's sense of responsibility to repay his or her debts.[191] There is no strong empirical evidence to support this connection.[192]

[187] See above nn 26–9 and accompanying text.

[188] Douglass Boshkoff, 'Limited, Conditional, and Suspended Discharges in Anglo-American Bankruptcy Proceedings' (1982) 131 *University of Pennsylvania Law Review* 69, 125. See also Keay, 'Balancing Interests in Bankruptcy Law', above n 21, 208–18; ALRC, *Insolvency: The Regular Payment of Debts*, above n 5, [3]. See generally Gross, above n 172, 15–24.

[189] Keay, 'Balancing Interests in Bankruptcy Law', above n 21, 218.

[190] Niemi-Kiesiläinen, Ramsay and Whitford, 'Introduction', above n 149, 6.

[191] Submissions to the ALRC concerning the *General Insolvency Inquiry*, above n 26, which supported such a proposition included: Queensland Law Society, Submission No 170 (December 1987) ch 11; Director of Public Prosecutions, Submission No 139 (November 1987) 30; Law Council of Australia, Submission No 194 (March 1988) 30.

Nevertheless, these considerations support a discharge period of sufficient length to minimise abuse. Alternatively, there must be mechanisms in place to ensure that a shorter discharge period does not lead to abuse.

2 *Particular Interests*

The next step is to identify the particular interests relevant to the discharge period. Discharge is the fundamental objective of consumer bankruptcy[193] and should not be postponed without good reason. It is rational to consider the reasons behind discharge before determining how it should be qualified. A number of theories have been offered for the bankruptcy discharge. This section argues that each of these theories may be adapted and applied to reveal the particular interests of creditors, debtors and the community relevant to the discharge period.

(a) Debtor Cooperation Theory

The provenance of discharge lies in the theory that it would encourage debtor cooperation. Discharge was introduced in 1705 in England in an attempt to 'minimise the prevailing dread of bankruptcy by providing inducement for traders to disclose financial problems early and behave honestly.'[194] It reflected the fact that bankruptcy was a form of criminal law, providing a summary, harsh and coercive method of collecting outstanding debts from deviant bankrupts.[195] The problem was that the harshness of bankruptcy meant debtors devised various tactics, such as hiding assets, which frustrated collection attempts. Discharge was intended to mitigate this problem. The possibility of discharge gave the debtor an incentive to surrender his or her assets for distribution, which increased creditors' dividends and reduced administrative costs. If the debtor cooperated, discharge was granted; if not, it was denied. Thus discharge was merely to aid collection; any relief to debtors was incidental[196] or, at most, secondary.[197] The rationale for discharge evolved over 200 years from a creditors' collection tool to a debtor relief system.[198] The debtor cooperation theory now justifies delaying discharge for non-compliant debtors. A 'carrot and stick' approach would tend to compel debtor cooperation.

192 Ramsay, 'Models of Consumer Bankruptcy', above n 35, 272.

193 See above Part II(B).

194 Ian Duffy, 'English Bankrupts, 1571–1861' (1980) 24 *American Journal of Legal History* 283, 287. See also Charles Tabb, 'The Scope of the Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate' (1990) 59 *George Washington Law Review* 56, 90.

195 See Ramsay, 'Models of Consumer Bankruptcy', above n 35, 270.

196 John Honsberger, 'Philosophy and Design of Modern Fresh Start Policies: The Evolution of Canada's Legislative Policy' (1999) 37 *Osgoode Hall Law Journal* 171, 175–7; Howard, above n 35, 1049.

197 Charles Tabb, 'The Historical Evolution of the Bankruptcy Discharge' (1991) 65 *American Bankruptcy Law Journal* 325, 337–9.

198 Ibid 370.

(b) Social Utility Theory

Another traditional theory justifies discharge as avoiding or minimising some of the social costs of over-indebtedness, in that discharge 'simultaneously removes the debtor's incentive to rely on inefficient state aid and renews her incentive to contribute to the gross national product.'[199] This theory has two main aspects. The first is the 'fabric of society' argument; that is, a large number of bankrupts weakens the fabric of society.[200] The pressure of debt may cause the debtor to lose incentive to produce income, preferring to rely on community welfare programs instead.[201] Discharge minimises the debtor's reliance on public support. It shifts the risk of loss from community welfare programs to creditors. This encourages creditors to take steps to minimise the risk of loss and monitor extensions of credit.[202] Creditors may, for example, pursue more conservative lending policies or raise interest rates.[203] Thus, discharge reduces the overextension of credit, which reduces the need to resort to bankruptcy, thereby reducing the use of community welfare.[204] The assumption is that creditors are in the best position to regulate the individual's consumption of credit.[205]

This first aspect of the social utility theory justifies a short discharge period. Undischarged bankrupts can weaken the fabric of society in the same way as an over-indebted individual. If an impoverished class of bankrupts is causing social dislocation, keeping them impoverished for an extended period of time will only add to the larger social problem. The discharge period should be as short as possible to minimise a bankrupt's reliance on social welfare. In 1970, the Canadian Tasse Committee recommended a short discharge period primarily because of the 'great social waste' that undischarged bankrupts constituted.[206] According to the Committee, whose views the ALRC endorsed, bankruptcy should 'minimize this waste', 'make the most of the human resources represented by this group of debtors' and encourage a debtor 'to become, *as quickly as possible*, a self-supporting and productive member' of the community.[207]

A short discharge period can also be justified as minimising the administrative costs of bankruptcy. Although it was not discussed during the parliamentary debates, an important economic justification for the introduction of early

199 Adam Hirsch, 'Inheritance and Bankruptcy: The Meaning of the "Fresh Start"' (1994) 45 *Hastings Law Journal* 175, 208.

200 Tabb, 'The Scope of the Fresh Start in Bankruptcy', above n 194, 94.

201 Jackson, *The Logic and Limits of Bankruptcy Law*, above n 164, 231.

202 Charles Hallinan, 'The "Fresh Start" Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory' (1986) 21 *University of Richmond Law Review* 49, 62–4, 68; Niemi-Kiesiläinen, Ramsay and Whitford, 'Introduction', above n 149, 7; Jackson, *The Logic and Limits of Bankruptcy Law*, above n 164, 231.

203 See, eg, Thomas Jackson, 'The Fresh-Start Policy in Bankruptcy Law' (1985) 98 *Harvard Law Review* 1393, 1402.

204 Rafael Efrat, 'The Fresh Start-Policy in Bankruptcy in Modern Day Israel' (1999) 7 *American Bankruptcy Institute Law Review* 555, 563.

205 See especially Howard, above n 35, 1063–6. See also Hallinan, above n 202, 68; Jackson, 'The Fresh-Start Policy in Bankruptcy Law', above n 203, 1426. Cf Theodore Eisenberg, 'Bankruptcy Law in Perspective' (1981) 28 *UCLA Law Review* 953, 981–2.

206 Study Committee on Bankruptcy and Insolvency Legislation, above n 31, 87, quoted in ALRC, *Insolvency: The Regular Payment of Debts*, above n 5, [141].

207 Ibid (emphasis added). See also Honsberger, above n 196, 184–6.

discharge in Australia was that it achieved cost savings in the administration of bankruptcy cases.[208] The longer a person remains in bankruptcy, the more taxpayer funds are needed to administer the estate.[209] A shorter discharge period would minimise these administrative costs. This justification is particularly strong in cases where there is little or no likelihood of recovering these costs. This is the case for the typical consumer bankrupt. As noted above, around 60 per cent of new bankrupts were eligible for early discharge,[210] meaning that they did not have enough money to pay the trustee's costs.[211]

The second and related aspect of the social utility theory justifies discharge on the basis of economic rehabilitation. As early as 1765, Sir William Blackstone noted that discharge enabled the bankrupt to 'become a u[s]eful member of the commonwealth'.[212] An over-indebted individual has little incentive to remain productive because most of his or her earnings go to creditors. Debtors are likely to enjoy more leisure, which decreases their productive contributions to the community.[213] Discharging the debtor restores him or her to economic productivity. The debtor is more likely to work hard if the possibility of retaining the benefits of that work exists.[214]

A leading proponent of economic rehabilitation is Margaret Howard.[215] The sole purpose of discharge, according to Howard, is to restore economic function. Her 'functional economic approach' to discharge is that the importance of economic rehabilitation means discharge should be 'broadly available'. There is an important caveat: the scope of discharge should be limited as necessary to prevent skewing of economic decisions.[216] In other words, the availability of discharge should not be such as to affect decisions about whether to lend or borrow.

This second facet of the social utility theory is also applicable to the discharge period. An unduly long period postpones the effective reintegration of the debtor into the mainstream economy. Investigations into the affairs of the typical consumer debtor are relatively brief. In Australia, for example, the administration process for the average consumer debtor is usually completed within a few weeks.[217] Social utility theory dictates that a bankrupt should be discharged as soon as these investigations are complete. The ALRC has argued that a short discharge period is appropriate because the function of the discharge should be to

208 See Weule, above n 100, 13.

209 Australia is unusual in this respect. The systems of Canada, the United States and the United Kingdom, in essence, require debtors pay the administration costs before filing: Jacob Ziegel, *Comparative Consumer Insolvency Regimes — A Canadian Perspective* (2003) 20 (in relation to Canada), 61 (United States), 97 (Australia), 112–13 (UK).

210 See above n 109 and accompanying text.

211 See *Bankruptcy Act 1966* (Cth) s 149T(a)(i) (repealed).

212 Sir William Blackstone, *Commentaries on the Laws of England* (first published 1765, 4th ed, 1771) vol 2, 484.

213 Jackson, *The Logic and Limits of Bankruptcy Law*, above n 164, 244–5.

214 Gross, above n 172, 94.

215 Howard, above n 35, 1047. See also Nicholas Georgakopoulos, 'Bankruptcy Law For Productivity' (2002) 37 *Wake Forest Law Review* 51.

216 Howard, above n 35, 1069.

217 ALRC, *General Insolvency Inquiry*, above n 26, [421], [550].

enable debtors 'to be restored to full commercial capacity and productive participation in the economy.'[218] It noted that 'if a person continues to be bankrupt it may create a disincentive for that person to pursue full productivity.'[219] Bankruptcy imposes various limitations on the debtor's ability and desire to earn. Productivity is unrealised. Once in bankruptcy, a longer discharge period encourages a negative attitude. There is little incentive for bankrupts to use their full employment capacity or to acquire property because the income or property may be used to meet bankruptcy debts.[220]

Applying Howard's functional economic approach, the length of the discharge period should be short so as to restore the debtor to productivity. However, the approach's caveat provides that the length of the discharge period should not introduce non-economic factors into decisions regarding lending and borrowing. For example, a debtor with the knowledge that a quick discharge is available at the back of his or her mind may make decisions to borrow money negligently, recklessly or dishonestly. These kinds of effects may lead to a kind of 'rogue's charter'. This caveat is similar to the general interest discussed above, that bankruptcy not be abused.[221]

(c) Humanitarian Theory

A third major, if somewhat elusive, theory justifies discharge using a natural law concept of morality.[222] The first aspect of this humanitarian theory focuses on society's duty to rehabilitate the debtor. According to Gross: 'Rehabilitating debtors is part of the responsibility to treat members of society humanely. It promotes values of human dignity and self-respect.'[223] Discharge is part of the community's commitment to the fundamental dignity of the debtor. The second aspect of humanitarian theory focuses on how the debtor and society benefit from this rehabilitation.[224] In terms of community benefits, Gross argues that, apart from their intrinsic self-worth, dignity and self-respect translate into economic benefits for the community and debtors. While acknowledging that they are difficult to quantify, discharge stabilises families, allows the quest for greater prosperity and ensures better physical and emotional health.[225]

Discharge relieves debtors of the psychological, emotional and financial weight of a high level of debt.[226] There is limited empirical support for these psychological benefits.[227] A 1989 study of Australian consumer bankrupts by Martin Ryan, however, found the extent of physical and emotional problems

[218] Ibid [550]. See also ALRC, *Insolvency: The Regular Payment of Debts*, above n 5, [140].
[219] Ibid.
[220] Ibid [343].
[221] See above Part IV(B)(1).
[222] Flint, above n 33, 519–20.
[223] Gross, above n 172, 102.
[224] Tabb, 'The Scope of the Fresh Start in Bankruptcy', above n 194, 95.
[225] Gross, above n 172, 102.
[226] Lawrence Ponoroff and F Stephen Knippenberg, 'Debtors Who Convert Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?' (1995) *New York University Law Review* 235, 248.
[227] Howard, above n 35, 1061.

linked to debt problems was high.[228] Other studies have also found adverse consequences associated with a high level of debt.[229] The relevance of these psychological goals to the discharge period is somewhat unclear. The anecdotal evidence is conflicting. Betty Weule, a financial counsellor, has argued that 'the main benefit to the bankrupt of early discharge is psychological' because of the stress, shame and lowering of self-respect that life as an undischarged bankrupt entails.[230] By contrast, Ryan concluded that 'bankruptcy was a much less traumatic experience … than might have been thought, both financially and emotionally.'[231] Some financial counsellors have 'asserted that the period of bankruptcy does not have a significant impact on the lives of bankrupts with no assets and low incomes'.[232] More empirical work is needed. The application of humanitarian theory depends on whether empirical evidence suggests life as an undischarged bankrupt is psychologically and emotionally damaging. If it does, then the humanitarian theory would justify a short discharge period.

(d) Entrepreneurship Theory

Discharge may also be justified as an individual form of limited liability.[233] According to this theory, the fundamental purpose of discharge is to foster entrepreneurship. A debtor with the knowledge that failure will not lead to debt servitude is more confident in taking risks.[234] Discharge acts as a safeguard that provides entrepreneurs with an incentive to start new business ventures. This is beneficial to the community because 'entrepreneurship is the driving force behind the market process and, thus, the growth of knowledge in society'.[235] However, if the discharge policy is too liberal, it may encourage investment in inefficient ventures. The community is partially protected because a debtor knows that if he or she acts dishonestly, discharge will be delayed. The key goal is fostering the environment that best encourages the entrepreneur to act without making it so inviting that the entrepreneur acts too rashly in taking unacceptable risks.[236]

The entrepreneurship theory is directly applicable to the discharge period. A longer discharge period will cause the debtor to be more hesitant and less likely to act entrepreneurially. Similar reasoning provided the key justification for the United Kingdom's reduction of its general discharge period from three years to

228 Martin Ryan, *The Last Resort: A Study of Consumer Bankrupts* (1995) 213. The 1989 study was first reported in Martin Ryan, *The Last Resort: An Empirical Study of Non-Business Voluntary Bankrupts in Melbourne, Australia* (D Phil Thesis, La Trobe University, 1989).

229 See Efrat, 'The Fresh Start-Policy in Bankruptcy in Modern Day Israel', above n 204, 561 fn 31.

230 Weule, above n 100, 12.

231 Ryan, *The Last Resort: A Study of Consumer Bankrupts*, above n 228, 225.

232 ALRC, *General Insolvency Inquiry*, above n 26, [548].

233 Jackson, *The Logic and Limits of Bankruptcy Law*, above n 164, 229.

234 John Czarnetzky, 'The Individual and Failure: A Theory of the Bankruptcy Discharge' (2000) 32 *Arizona State Law Journal* 393, 399.

235 Ibid 413–14; European Commission, *Best Project on Restructuring, Bankruptcy and a Fresh Start*, above n 17, [7.4.4].

236 Czarnetzky, above n 234, 405–12.

between two and 12 months.[237] The reduction was primarily designed to 'encourage entrepreneurship and responsible risk taking'.[238] Similarly, the European Commission noted that 'long discharge periods obstruct the possibility of a fresh start'[239] and concluded that, for honest bankrupts, '[e]arly discharge from remaining debts is crucial to promote fresh starts and entrepreneurial activity.'[240] However, consumer bankrupts are far less likely to engage in entrepreneurial activity than business bankrupts. The entrepreneurship theory may be more applicable in countries like the United Kingdom, which have a far higher proportion of business-related bankruptcies than Australia. In 1998–99, for example, 65 per cent of bankruptcies in the United Kingdom were business-related, compared to only 11 per cent in Australia.[241] In addition, many entrepreneurs are able to incorporate and thus limit their liability. The relevance of the entrepreneurship theory to the discharge period in Australia is therefore limited.

(e) Systematic Overborrowing Theory

Jackson justifies a non-waivable right to discharge as the best means of overcoming defects in an individual's volitional and cognitive processes. Many individuals have a volitional problem whereby they simply cannot control their impulse to buy or borrow on credit and thus incur too much debt.[242] A closely related cognitive problem of 'incomplete heuristics' means individuals systematically underestimate the future risk that they will be unable to pay for their current consumption level.[243] The two problems in combination mean that many people will suffer distortions in making credit decisions. Discharge partially shifts the risk of loss to creditors. It overcomes the problem of incomplete heuristics and 'controls impulsive credit decisions by encouraging creditors to monitor borrowing.'[244]

A longer discharge period can also be justified as a means of addressing the problems of impulsiveness and incomplete heuristics. As early as 1977, the ALRC was of the view that a discharged debtor should 'return to the market with an improved sense of budgeting and of the danger of overcommitment of meagre income' and 'a proper understanding of credit and a sense of his own responsi-

[237] See generally Andrew Keay, 'The Enterprise Act 2002: Pioneering a Brave New World in Insolvency Law in the United Kingdom?' (2003) 11 *Insolvency Law Journal* 163.

[238] Insolvency Service, Department of Trade and Industry, United Kingdom, *Productivity and Enterprise: Insolvency — A Second Chance*, Cm 5234 (2001) [1.1] <http://www.insolvency.gov.uk/cwp/cm5234.pdf>.

[239] European Commission, *Bankruptcy and a Fresh Start*, above n 17, 335.

[240] European Commission, *Best Project on Restructuring, Bankruptcy and a Fresh Start*, above n 17, [7.3.4] (emphasis omitted).

[241] Insolvency Service, Department of Trade and Industry, United Kingdom, *Bankruptcy — A Fresh Start: A Consultation on Possible Reform to the Law Relating to Personal Insolvency in England and Wales* (2000) [2.3] <http://www.insolvency.gov.uk/pdfs/freshstart.pdf>. This assumes that it is possible to distinguish between business bankrupts and consumer bankrupts in practice.

[242] Jackson, *The Logic and Limits of Bankruptcy Law*, above n 164, 233–7.

[243] Ibid 237–41.

[244] Ibid 236.

bilities'.[245] Some countries provide debtors with counselling and training in financial management.[246] Australia does not, apart from giving potential bankrupts a brochure outlining their options,[247] so any educative effect would be fortuitous and ancillary. A longer discharge period may serve a consumer education function. One financial counselling organisation has argued that 'there is some rehabilitation value in a longer period of bankruptcy'.[248] The Australian study by Ryan reached the same conclusion, finding that the process of having 'time out', even without supervision or monitoring, induced changes in financial behaviour.[249] These included becoming more dependent on cash rather than credit, using budgets, using lay-bys, using bankruptcy to save money, living a more frugal lifestyle and critically evaluating the pre-bankruptcy lifestyle. Significantly, participants mentioned six to 12 months as the period necessary to make these changes.[250]

C *Distilling a Policy Approach*

The length of the discharge period is driven, in differing degrees, by a number of policies. The social utility theory, entrepreneurship theory, humanitarian theory and systematic overborrowing theory are all instructive. Each theory encompasses the relevant particular interests of debtors, creditors and the community. The balanced approach advocated in this Part provides that the appropriate discharge period should represent a balance of these particular interests. It should also balance the general interests relevant to all bankruptcy laws. More specifically, it should take account of the interest of creditors and the community that bankruptcy should not be abused. Part V takes the final step and applies this approach to the discharge period.

V FINDING THE RIGHT BALANCE

This Part considers the practical question of how the competing particular and general interests relevant to the discharge period may be balanced. It argues that the standard three year discharge period fails to comply with the policy approach advocated in Part IV. It argues instead that an equitable balance supports a shorter discharge period with eligibility criteria to prevent its abuse.

245 ALRC, *Insolvency: The Regular Payment of Debts*, above n 5, [142].

246 See generally Johanna Niemi-Kiesiläinen, Iain Ramsay and William Whitford (eds), *Consumer Bankruptcy in Global Perspective* (2003) pt V ('Debtor Education and Debtor Counselling'); Iain Ramsay, 'Mandatory Bankruptcy Counseling: The Canadian Experience' (2001) 7 *Fordham Journal of Corporate and Financial Law* 525.

247 Under reg 4.11 of the *Bankruptcy Regulations 1996* (Cth), a debtor petitioning for bankruptcy must be supplied with certain prescribed information covering bankruptcy's alternatives and consequences, and sources of financial advice or guidance.

248 ALRC, *General Insolvency Inquiry*, above n 26, [548], referring to Consumer Credit Legal Service, Submission No 163 (December 1987) 16.

249 Ryan, *The Last Resort: A Study of Consumer Bankrupts*, above n 228, 247.

250 Ibid.

A *Balancing the Particular Interests*

It is submitted that on balance, the relevant particular interests reviewed above support a short discharge period; that is, one that does not extend significantly beyond the investigation into the bankrupt's affairs. The social utility theory supports a short discharge period in the community interest, because it encourages creditor monitoring, reduces reliance on community welfare programs, minimises the administrative cost of bankruptcies and restores a debtor to economic productivity more quickly. The entrepreneurship theory justifies a short discharge period in the community interest because it fosters risk-taking for the benefit of the economy. A short discharge period is in the debtor's interests under the humanitarian theory because it minimises any emotional and psychological impact of bankruptcy.

In contrast, systematic overborrowing theory justifies a longer discharge period as one way of minimising debtors' volitional and cognitive deficiencies. Bankrupts have more time to learn from their mistakes. The establishment of debtor education and counselling programs, however, may be a more effective means of addressing these deficiencies[251] and their existence would also justify a shorter period under this theory.

Even without these measures, the balance of the particular interests suggests that Australia should take more of an 'automatic door' approach to a short discharge period;[252] that is, any debtor should be able to walk in through the door of bankruptcy and then, soon after they have been investigated, walk out though the door of discharge.

B *Balancing the General Interests*

The discharge period should also balance the general interests of creditors, debtors and the community. Clearly, a short period is in the debtor's interests. A shortening of the discharge period would, on its face, disadvantage the interests of creditors. After-acquired property, which currently goes to the creditor, would be reduced.[253] This is unlikely to be material as few bankrupts acquire property in these circumstances. Slightly more serious is the fact that income contributions would be lost.[254] As noted above, however, only around two to three per cent of bankrupts are liable to contribute each year. Moreover, this problem could be overcome. Part of a new shortened discharge system could ensure that the small proportion of bankrupts affected remain liable to make income contributions for a period beyond discharge. Alternatively, bankrupts liable to

[251] In theory, mandatory counselling is effective, but the practical value is unclear. See Susan Block-Lieb, Karen Gross and Richard Wiener, 'Lessons from the Trenches: Debtor Education in Theory and Practice' (2002) 7 *Fordham Journal of Corporate and Financial Law* 503, 508; Ramsay, 'Mandatory Bankruptcy Counseling', above n 246, 536–9.

[252] Kent Anderson, 'Small Businesses Reorganizations: An Examination of Japan's Civil Rehabilitation Act considering US Policy Implications and Foreign Creditors' Practical Interests' (2001) 75 *American Bankruptcy Law Journal* 355, 403.

[253] See above n 38 and accompanying text.

[254] See above Part II(C)(4).

make income contributions could be disqualified from the shorter discharge period, as was the case with early discharge.

The discharge period should also balance community and creditor interests in preventing abuse of bankruptcy law. Part III showed that this problem is minimal. Nevertheless, in theory at least, a longer discharge period can be justified as increasing the deterrent effect of bankruptcy and minimising the abuse problem. The current three year period can be defended in this way. However, it arguably overemphasises the general interest in preventing abuse at the expense of the other relevant particular interests. Conversely, the automatic door approach outlined above likely overemphasises the particular interests. An optimal law would address both the general and particular interests.

An alternative approach, which could be called the 'doorman approach',[255] would subject debtors to an inspection when they walk through the door of bankruptcy and only allow certain debtors to receive a short discharge. Practically, this means using eligibility criteria to distinguish between types of debtors. An early discharge would be reserved for unfortunate bankrupts. The criteria should ensure that fraudulent bankrupts, reckless bankrupts and bankrupts able to repay their debts serve a longer discharge period. This would minimise abuse and accord with community interests. Taking this approach ensures a more equitable balance. It better accommodates the relevant interests than the standard three year period. A short discharge period addresses the relevant particular interests, while using eligibility criteria addresses the relevant general interests. In terms of length, on a balanced approach, discharge should occur shortly after the investigation period. The difficult practical question then becomes how the distinction between eligible bankrupts can be made. It is now argued that, with minor modifications, the previous early discharge provisions are suitable.

C *Practical Issues*

The Official Trustee[256] could act as the doorman. There would be two phases — the eligibility phase and the discretion phase. First, the Trustee would assess a debtor's eligibility when he or she petitions for bankruptcy relief. While this may result in slightly increased administrative costs, Official Trustees already have to investigate bankrupts at the petition stage. The early discharge criteria aimed at disqualifying fraudulent bankrupts appeared to be successful and could be reintroduced. Repeat bankrupts could also be disqualified to prevent repeat abuse. The main difficulty occurs when attempting to disqualify reckless bankrupts. The 150 per cent rule could be reused as a 'bright-line test', but with provision for the debtor to appeal to the Official Trustee and Administrative Appeals Tribunal to minimise the possible discrimination and injustice outlined in Part III.[257] The large majority of bankrupts would still qualify, as was the case with the previous early discharge system. It must be realised that any set of

[255] Anderson, above n 252, 403.

[256] The Official Trustee is a corporation: see s 18 of the *Bankrutpcy Act 1966* (Cth). It acts as the trustee of a bankrupt estate where a registered trustee has not been appointed: s 160.

[257] See above nn 103–7 and accompanying text.

criteria will not be completely effective and some fraudulent or reckless bankrupts will slip through the doorman's inspection. However, the large majority of bankrupts should not be forced to suffer a long discharge period simply in order to prevent this.

Second, the Trustee would exercise his or her discretion. The Trustee now has the discretion to reject a debtor's petition where it appears that, within a reasonable time, the debtor could pay all of his or her debts and the petition is an abuse of the bankruptcy system.[258] This discretion should largely eliminate one form of abuse. An alternative to using the 150 per cent rule as a bright line test would be to supplement it with provision for Trustee discretion subject to certain guidelines to ensure fairness and consistency. While this may minimise the rule's potential for discrimination and injustice, administration costs would increase and formulating guidelines is problematic.[259] At the point of discharge, objections can be made to delay bankruptcy.[260] This ensures the cooperation of the bankrupt in the process and discourages fraud.

VI CONCLUSION

The simplistic notion that bankruptcy laws represent the result of a game of tug of war between debtors and creditors is not conducive to developing appropriate legislation. The natural result is that gains to one side will eventually be countered by gains to the other. The law is either 'creditor-friendly' or 'debtor-friendly'. There is no room for a consistent underlying policy approach; ad hoc decision-making swings on the basis of anecdotal evidence and perceived problems.

This was evident in Australia's experience with early discharge. Early discharge was introduced to enhance the opportunities of certain debtors and all the evidence suggests that it achieved this aim. The aim itself is also justifiable from a theoretical perspective. After 10 years it was abolished, mainly because it was perceived as making bankruptcy too easy. However, this was based merely on anecdotal evidence from creditors. This general argument and the various specific arguments that were raised in favour of abolition lacked solid evidence, were misdirected or disputable and contradicted the available evidence.

Bankruptcy has become such an integral part of our commercial and social welfare system that it must be considered and debated at a more sophisticated level. The balanced approach advocated in this article recognises the complicated interests of debtors, creditors and the community, and shifts the focus to whether the law equitably balances these interests. This approach can be applied both to bankruptcy law generally and, more importantly, to specific laws. The rational, structured approach advocated in this article illustrates how the balanced approach can apply to specific laws such as the discharge period on both the theoretical and practical levels. It is particularly applicable to laws that operate to

[258] *Bankruptcy Act 1966* (Cth) s 55(3AA). This was introduced by the *Bankruptcy Amendment Act 2002* (Cth).

[259] See generally Keay, 'Balancing Interests in Bankruptcy Law', above n 21, 228–31.

[260] See above Part II(C)(5).

deter or obstruct the fresh start principle. It is surely time to move beyond simplistic notions and fully engage with bankruptcy law at the theoretical and policy level.