

# **AFTER-ACQUIRED INCOME AND CONTRIBUTIONS BY AUSTRALIAN BANKRUPTS: CAN PAY, SHOULD PAY, MAKING THEM PAY!**

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*This article explores the issue of income of bankrupts from the historical, theoretical and legislative viewpoints. After setting out the foundation for our present law, the article reviews the current statistics on the use of the existing legislative income contribution regime and analyses the jurisprudence which has made the notion of after-acquired income - and the ability of bankrupts to invest it - opaque. The article then canvasses the 'can pay, should pay' notion of income contributions by bankrupts together with the current debate on 'making them pay'.*

## I INTRODUCTION

One of the distinguishing features of personal insolvency is that it always contemplates the ongoing financial life of the bankrupt. Central to this are the rules providing for exempt property and the encouragement to continue in employment to advance the well-being of the individual bankrupt and his/her dependents. A bankrupt's life continues despite his/her bankruptcy and therefore bankrupts have the basic needs to provide themselves and their dependents shelter and food. These needs are met either by the bankrupt collecting social security benefits (due to unemployment or disability) or by employed bankrupts earning an income. It is in respect of such 'income' that Australian bankruptcy trustees are required to make a contribution assessment. After-acquired income, so called because it is acquired following the commencement of bankruptcy, will be present throughout the period of bankruptcy. Such income assumes an important role in a bankruptcy administration due to the imposed legislative requirement and expressed object of requiring a bankrupt to pay contributions. From the existence of this after-acquired income comes the expectation that a contribution to creditors may be possible.

The present Australian approach is to permit the trustee-in-bankruptcy to determine the amount of after-acquired income that will form a contribution to creditors and the legislation sets out the several matters that assist in making the determination. This appears to be a preferred approach to that of requiring the trustee to apply to court for

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an order with respect to the amount of income that must be contributed to the bankrupt's creditors (as in the UK).

Australia's current income contribution regime for bankrupts commenced in 1992 and was introduced to address "expressions of concern in the community that legislative measures should be taken to make [the mechanisms for obtaining income contributions] ... more effective, but not in such a way as to operate to the disadvantage of persons with low incomes."<sup>1</sup> Does this aspect of Australia's bankruptcy law currently steer the right course between the two (generally denounced) outcomes of bankrupt 'slavery' on the one hand and the lack of reciprocal responsibility on the other? The analysis which follows is an attempt to shed some light on this question by exploring and considering the historical, theoretical and statistical perspectives on Australia's income contribution regime as well as the key cases in which courts have had to apply and/or construe the critical provisions of the relevant legislation.

## II THE HISTORY OF INCOME CONTRIBUTIONS

The concept of after-acquired property and income from bankrupts has a long history in Britain. Legislation in 1849 expressly provided that property may 'revert, descend, be devised or bequeathed or come to' a bankrupt and will vest in the estate. 1869 legislation provided that where a bankrupt 'was in receipt of salary or income ... the court on application of the trustee could make such orders as it thought just.' Both these provisions found their way into the 1883 legislation and were later translated into the UK's Bankruptcy Act 1914.

When the *Bankruptcy Act 1924* (Cth) was drafted it contained the following provision:

101 Subject to this Act, where a bankrupt is in receipt of pay, pension, salary, emoluments, profits, wages, earnings, or income, the trustee shall receive for distribution amongst the creditors so much thereof as the Court, on the application of the trustee, directs.

While UK case law suggested that whatever property the bankrupt acquires before discharge 'belongs' to the trustee 'save only what is necessary for his support', an Australian court rejected this interpretation of income vesting in the trustee for the purposes of s 101, as did the Clyne Committee in 1962.<sup>2</sup> The Clyne Committee suggested the section be recast so that, subject to any order of the court, a bankrupt who was in receipt of income should be entitled to retain it for their own benefit.

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<sup>1</sup> Explanatory Memorandum, Bankruptcy Amendment Bill 1991, 2 [2].

<sup>2</sup> *Federal Commissioner of Taxation v Official Receiver* (1956) 95 CLR 300; Committee appointed by the Attorney General of the Commonwealth to Review the Bankruptcy Law of the Commonwealth 1962 (Clyne Committee), at paragraph 197-201.

The 1966 legislation took on board the Clyne Committee's suggestion to recast the provision. Section 131(1) provided that a person who became bankrupt was entitled to retain his income for his own benefit and 'income' was to be interpreted widely. As Rose commented 'no formula can be given to determine its precise scope'.<sup>3</sup>

In 1992 amending legislation was inserted into the *Bankruptcy Act 1966* (Cth) ('the Act') the current Division 4B, entitled 'Contribution by bankrupt and recovery of property' and this includes the statement of objects in s 139J. Importantly, after-acquired income does not vest in the trustee.<sup>4</sup>

### III THE THEORETICAL OBJECTIVES

One of the objects of Division 4B of Part VI of the Act is to require a bankrupt who derives income during the bankruptcy to pay contributions towards the bankrupt's estate. We know this because s 139J(a) expressly mentions it. This particular division has been described by the Federal Court as one that 'approaches a code' for dealing with after-acquired income of a bankrupt.<sup>5</sup>

To achieve this object it has been necessary to have provisions which permit the trustee to make an assessment of the contribution expected from the bankrupt and several determinations such as whether the bankrupt has received reasonable remuneration in respect of employment or from any transaction entered into during the assessment period. Persons other than the bankrupt (including the bankrupt's employer) can be required to make payments in order to achieve the same stated object.

Insolvency laws aim to be efficient, fair and accountable and arguably, even some specific provisions will deter.<sup>6</sup> The income 'code' certainly ticks some of these boxes. Firstly, the provisions provide for a formula that aims to calculate efficiently just how much the income contribution will be. Secondly, the very fact that a bankrupt can keep income from his or her employment suggests an attempt at achieving fairness between the creditors (who are suffering some shortfall in their lawful claims) and the bankrupt's attempt at a fresh start and the need to have some money to live. Thirdly, the code is quite detailed in making the bankrupt accountable for the income and it specifically targets others associated with the bankrupt who are corralled into paying the earnings or to make transfers direct to the trustee in lieu of the bankrupt. Fourthly, there is a clear association with some of the offences found in Part XIV of the Act with express terms of imprisonment that serve to deter non-compliance with the 'code'.

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<sup>3</sup> D J Rose, *Lewis Australian Bankruptcy Law* (Law Book Co, 8<sup>th</sup> ed, 1984) 150.

<sup>4</sup> *Re Gillies; Ex parte Official Trustee in Bankruptcy* (1993) 42 FCR 571; 115 ALR 631, 576-577, [11] (French J).

<sup>5</sup> *Ibid.*

<sup>6</sup> Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2<sup>nd</sup> ed, 2009).

In his book *The Ethics of Bankruptcy*, Kilpi makes a link between discharge and income contributions, stating that, along with the exempt property rules, these income contributions expectations are matters 'of community judgment relative to community standards' provided they remove the threat of debt bondage.<sup>7</sup> Later he proffers a justification for income orders. His preamble though is insightful:

Even if one is happy to accept that income orders may be enforced to satisfy the creditors, it should be borne in mind that honest debtors, those who sincerely have sought to pay their debts, have not committed a moral wrong deserving of punishment, nor would it be beneficial to punish them. *The justification of income orders can come only from the monetary gain to the estate*<sup>8</sup> (emphasis added).

So if we accept this justification, the present Division 4B of Part VI of our bankruptcy legislation should be written to increase the distributions to creditors and not to provide punishment or hardship to the bankrupt.

#### IV THE CURRENT LEGISLATIVE PROVISIONS

The Explanatory Memorandum to the amending legislation in 1992 explained that the earlier provisions, requiring a trustee to approach the court for orders with regard to after-acquired income, 'had not been a particularly useful instrument for trustees because of the cost of court process and the self-defeating nature of the custodial sanction for non-compliance with the order.' The Explanatory Memorandum also referred to bankrupts who earned large incomes and for all practical purposes were not required to make any repayments and that the new 'code' was clearly being introduced to amend that situation.

Division 4B of Part VI of the Act requires that a bankrupt who derives income above a specified amount - a formula is contained in s 139S - during the period of their bankruptcy will pay a contribution towards the bankrupt estate. There is a threshold point at which the bankrupt becomes liable to pay and this is determined by reference to the pension rate in the *Social Security Act 1991* (Cth) and is increased having regard to the Consumer Price Index. The minimum income for compulsory contributions is referred to as the base income threshold amount ('BITA') with appropriate increases to this amount where the bankrupt has dependants. As at 20 March 2014 the BITA was \$52,543.40 (net of tax).<sup>9</sup> A bankrupt's income is assessed against the BITA every 12 months in order to determine the liability to make contributions.

To make the income contribution regime work effectively, Division 4B also contains:

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<sup>7</sup> Jukka Kilpi, *The Ethics of Bankruptcy* (Routledge, 1998) 87.

<sup>8</sup> *Ibid* 147.

<sup>9</sup> Sourced from AFSA's website, Australian Government, *Indexed Amounts* (23 July 2014) Australian Financial Security Authority <<http://www.afsa.gov.au/resources/fact-sheets/indexed-amounts>>. The limits are updated twice a year on 20 March and 20 September.

- provision for the assessment of deemed reasonable remuneration in circumstances where a bankrupt is working but not receiving the level of remuneration one would expect for that kind of employment (s 139Y of the Act); and
- ‘garnishee’ provisions which empower the Official Receiver (either as trustee or upon application by a registered trustee) to require employers (or debtors) of bankrupts to make payments of wages or debts directly to trustees in bankruptcy (Subdivision I of Division 4B of the Act).

The interaction of these two aspects of the income contribution regime will be discussed further below.

There is also a supervised account regime which essentially operates to provide trustees with the means to police and enforce the contribution obligations of a defaulting bankrupt (Subdivision HA of Division 4B of the Act).<sup>10</sup>

## V THE PRESENT POSITION FROM A STATISTICAL VIEWPOINT

The Annual Reports and Selected Statistics on Personal Insolvency released by ASFA (formerly ITSA)<sup>11</sup> present quite detailed information (in the form of tables) regarding the contributions made from income by bankrupts and other related matters. AFSA’s Selected Statistics on Personal Insolvency in 2012-13 (‘the 2012-13 AFSA Statistics’)<sup>12</sup> feature a key table in this regard: it provides the number of bankruptcies in which contributions were paid (including voluntary contributions) and the amounts contributed including a breakdown of those numbers according to the type of trustee (Table 3). Table 3 also provides a state-by-state breakdown of the bankruptcies in which contributions were paid and the amounts contributed. It is perhaps instructive at the outset to compare the amount of bankruptcies in which contributions were paid against the total number of new bankrupts in 2012-13: ie, 7,432 such bankruptcies against a total of 20,875 ‘new bankrupts’.<sup>13</sup>

In terms of Official Trustee administrations, the observable trend over the last three years appears to be a decrease in both contributors and aggregate contributions (ie,

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<sup>10</sup> The supervised account regime may only apply to a bankrupt who has defaulted at least once in respect of a contribution obligation: s 139ZIC(2) of the Act.

<sup>11</sup> On 15 August 2013 ITSA changed its name to the Australian Financial Security Authority (‘AFSA’). From 2012-13 AFSA has adopted the practice of publishing its range of personal insolvency statistics on its website earlier than its Annual Report.

<sup>12</sup> Released on 15 October 2013 and available on AFSA’s website at Australian Government, *Selected Statistics* (14 October 2013) Australian Financial Security Authority <<https://www.afsa.gov.au/resources/statistics/selected-statistics/selected-statistics>>.

<sup>13</sup> Figures sourced from Tables 1 and 3, AFSA Selected Statistics on Personal Insolvency in 2012-13, 3 and 6. According to Table 1 (Personal Insolvency Activity) there were 20,875 new Part IV and Part XI Bankruptcies in 2012-13. The figure of 7,432 is the aggregate of 2,382 Official Trustee-administered bankrupts and 5,050 registered trustee-administered bankrupts (see Table 3).

\$11.9 million from 3,121 'contributors' in 2010-11, \$11.2 million from 2,634 bankruptcies in 2011-12 and \$9.6 million from 2,382 bankruptcies in 2012-13).<sup>14</sup> It is concerning that recovered contributions appear to be falling - the reasons given in the ITSA Annual Report 2011-12 are that there has been an increase in debt agreements and the division of appointments between official and registered trustees.

In terms of the overall level of contributions, around \$45.1 million was contributed from 6,921 bankruptcies in 2011-12 which was an increase of \$8 million on 2010-2011.<sup>15</sup> The 2012-13 AFSA Statistics appear to reinforce this upward trend by reporting \$48.8 million of contributions from 7,432 bankruptcies in 2012-13. There were 2,382 bankruptcies administered by the Official Trustee in which income contributions totalling \$9,622,950 were made (an average contribution of \$4,040), while there were 5,050 bankruptcies administered by registered trustees which saw contributions totalling \$39,208,718 (an average contribution of \$7,764). The total number of bankruptcies in which contributions were paid was therefore 7,432 against a total population of bankrupts of between 27,527 and 28,304 in 2012-13.<sup>16</sup> This would indicate that approximately 26%-27% of bankrupts were contributing income towards their estate. As mentioned above, the 2012-13 AFSA Statistics also facilitate a state-by-state assessment of collections performance. The average registered trustee administration contributed \$7,781 in New South Wales/ACT, \$6,963 in Queensland and \$8,274 in South Australia/NT, while the average official trustee administration contributed \$4,659 in New South Wales/ACT, \$3,954 in Queensland and \$2,963 in South Australia/NT.<sup>17</sup>

In the ITSA Annual Report for 2011-12 there is a table showing the number of reviews of contribution assessments made by either the Official Trustee or a registered trustee (Table 8). Table 8 records the reviews of income contribution assessments conducted under the Act. The table indicates that in 2011-12 there were 34 bankrupts who appealed against their income assessments and that around half of those who appealed against registered trustee assessments had their contribution varied. One can only speculate as to why decisions by registered trustees would be so wayward, if they were indeed wayward. However, if the total number of 'contributing bankrupts' is 6,923 then the proportion of those seeking reviews is less than 1%.<sup>18</sup>

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<sup>14</sup> Figures sourced from ITSA Annual Report 2011-12, Table 15 (Contributions), 40 and AFSA Selected Statistics on Personal Insolvency in 2012-13, Table 3, 6.

<sup>15</sup> See AFSA Selected Statistics on Personal Insolvency in 2012-13 (Table 3), 6 and ITSA Annual Report 2010-2011.

<sup>16</sup> Numbers of Official Trustee and registered trustee administrations (Part IV and Part XI bankruptcies) 'on hand' at year-start and year-end sourced from Tables 21 and 22, ITSA Annual Report 2012-13, 74-75.

<sup>17</sup> AFSA Selected Statistics on Personal Insolvency in 2012-13 (Table 3), 6.

<sup>18</sup> The AFSA/ITSA Annual Report for 2012-2013 contains only one relevant table to this topic, Reviews of Income Contribution Assessments and it reveals similar data to the 2011-2012 Report

As the 2012-13 AFSA Statistics suggest, bankrupts who are not compelled to make an income contribution under the Act can still voluntarily contribute from their income. The 2012-13 AFSA Statistics do not identify the numbers who do, or the amounts that are contributed towards creditors in this manner.<sup>19</sup> Even those bankrupts who are compulsorily required to contribute could always make a contribution in excess of the s 139S formula amount. Again, there is no identification as to what extent this occurs if at all.

## VI THE FOG OF CASE LAW ON INCOME CONTRIBUTIONS

The Australian jurisprudence on income contributions could be best described as 'opaque'. The cases can be split into two major categories, those which consider the conversion of 'after-acquired income' into 'after-acquired property' and those in which the court has had to grapple with the question of just what constitutes 'income'.

### A *Recent cases on 'after-acquired income' converted to 'after-acquired property'*

#### 1 *Rodway v White*<sup>20</sup>

William Rodway (a bankrupt) earned \$155,440 income over two years during his bankruptcy and in compliance with ss 139P to 139ZP of the Act (Division 4B) he paid income contributions on this amount. With the income he was entitled to keep, the bankrupt purchased shares. He was subsequently charged and convicted with 21 offences under s 265(1)(a) of the Act for failing to disclose an interest in property – ie, the shares - to his trustee in bankruptcy. These shares had become 'after-acquired property' and therefore under s 116(1) they were 'divisible property' and so required disclosure.

Justice Heenan, sitting in the Western Australian Supreme Court, thought this was a 'novel question upon which no authoritative determination has been made'.<sup>21</sup> Rodway did not own the shares when he was made bankrupt (had this been the case he would have had to include them on his statement of affairs). He did not come by the shares by way of gift or otherwise whilst bankrupt (had this been the case he would have had to advise his trustee of his acquisition). In both these scenarios it is clear what is expected of the bankrupt and any breaches are expressly dealt with by the offences in Part XIV of the Act. Rodway purchased these shares while he was a bankrupt from income earned post-bankruptcy and before discharge, and which had

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with an almost identical number of reviews received and again around half having their contribution varied. See page 91.

<sup>19</sup> This is a deficiency in the published statistics in the authors' opinion.

<sup>20</sup> [2009] WASC 201.

<sup>21</sup> Ibid [33].

been the subject of income assessments. This situation is not expressly dealt with in the Act.

Before the case there were some certainties. One of these was that income of the bankrupt does not vest in the trustee in bankruptcy.<sup>22</sup> This was accepted by both sides.<sup>23</sup> Rodway was entitled to work, he had earned the money legitimately from personal exertion and it had been properly assessed for contributions. Another of the certainties was that shares are property.<sup>24</sup> The dispute was whether an item purchased with after-acquired income money was (or was not) ‘after-acquired property’, and if it was after-acquired property then why had it not been disclosed to the trustee. Additionally there was the question of whether the items purchased with after-acquired income *money* retained the same excluded or ‘protected’ nature as the original income *money*.

Heenan J acknowledged that ‘there is *some incongruity* in speaking of after-acquired income as not vesting in the trustee yet maintaining that after-acquired property (whether acquired with the use of that income or not) does.’<sup>25</sup> Yet in the same paragraph he states:

The accumulating cash on hand, and the accumulating balance in the bank or other account will each be a form of property of the bankrupt from the moment it is paid or received. There is no suggestion by the respondents [trustee], nor does the decision in Gilles [sic] (supra) appear to contemplate that the proceeds of income, whether it be cash or credits in bank accounts, as originally received or accumulated, will constitute ‘after-acquired’ property within the meaning of s 116.<sup>26</sup>

Then Heenan J states that ‘[t]his is *probably* due to the effect of Div 4B and the idea that after-acquired property does not include income at least in the form it was earned.’<sup>27</sup> In obiter, Heenan J contemplates that this income might travel around in different bank accounts and that each transition would ‘strictly speaking’ amount to an acquisition of property.<sup>28</sup> Heenan J resolved this by stating that ‘[t]he inconsistencies between this analysis of what constitutes property and the notion of ‘after-acquired property’ in s 116 can *probably* be ignored for the present notwithstanding that they reveal some special and fundamental changes to the conventional notion of “property”.’<sup>29</sup> With respect, such an analysis does not do justice to the central questions raised in the case. If Heenan J had been invited to or

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<sup>22</sup> Authority for this proposition is *Commissioner of Taxation v Official Receiver* (1956) 95 CLR 300; *Falstein v Official Receiver* [1962] HCA 65; (1962) 108 CLR 523; and *Re Gillies ex parte Official Trustee in Bankruptcy v Gillies* [1993] FCA 289; (1993) 42 FCR 571.

<sup>23</sup> *Rodway v White* [2009] WASC 201 [32].

<sup>24</sup> *Ibid* [30].

<sup>25</sup> *Ibid* [51].

<sup>26</sup> *Ibid*.

<sup>27</sup> *Ibid*.

<sup>28</sup> *Ibid*.

<sup>29</sup> *Ibid*.



was inclined to analyse an accounting treatment, where cash on hand, cash at bank and investments all have a similar position on a balance sheet, then he would not have proceeded as he did.

Heenan J, after conceding there was a certain degree of awkwardness in identifying the after-acquired income as property, decided that the conversion of income into a 'distinctly different' form of property will result in the acquisition of after-acquired property divisible among creditors and so vest in the trustee unless the property was exempt property.<sup>30</sup> He decided therefore that the property should have been disclosed to the trustee 'as soon as practicable' - as the words of s 77(1)(f) of the Act expressly require - and so the offences in s 265(1)(a) were made out.<sup>31</sup> Once Heenan J decided that the form of property had changed and it was now 'distinctly different' then there was no real question of 'protected' property.

Two cases featured in Heenan J's considerations and warrant analysis.

2 *Peter Andrew Gillies ex parte: The Official Trustee in Bankruptcy; the Trustee of the property of Peter Andrew Gillies ('Gillies')*<sup>32</sup>

Peter Gillies was a bankrupt who put forward a composition proposal where he offered a sum of money that he had accumulated from his income. He had previously paid an income contribution and there was one further payment to be made. The Official Trustee sought the court's directions on whether this accumulated income was after-acquired property and if he purchased assets with this accumulated income whether they would also be after-acquired property.

In *Gillies*, French J (as he then was) reviewed the history of the vesting of property and of a bankrupt's income in excess of that necessary for his support. French J's judgment also discussed the judicial exposition of the word 'income' before addressing the contributions provisions as they now stand in the Act. French J records that content of the current sections including ss 139P(1), 139Q, 139L, 139S, 139U, 139V, 139W, 139ZF, 139ZG, 139ZH, before arriving at 'the real issue' in the case, namely 'whether income in excess of the contribution to be made by the bankrupt has vested in the trustee'<sup>33</sup>. French J observed that there is a 'continuing assumption that the income of the bankrupt does not vest in the trustee' before further stating:

The liability to contribute is limited to half the excess of assessed income over the actual income threshold amount. Before it arises, a process of assessment is required to be undertaken by the trustee. It is true that the after-acquired property to which ss.58 and 116 apply is defined widely enough to encompass income. However, in my

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<sup>30</sup> Ibid [66].

<sup>31</sup> Ibid [67], [75].

<sup>32</sup> [1993] FCA 289; (1993) 42 FCR 571.

<sup>33</sup> *Peter Andrew Gillies ex parte: The Official Trustee in Bankruptcy; the Trustee of the property of Peter Andrew Gillies* [1993] FCA 289; (1993) 42 FCR 571, [10].

opinion, the legislative scheme now in place is quite inconsistent with the application of those provisions to after-acquired income. This follows from the comprehensive scheme embodied in Division 4B which approaches a code for dealing with after-acquired income of the bankrupt.<sup>34</sup>

After also observing that the extrinsic materials did not support a different interpretation, he decided that the accumulated income could be offered to creditors as a composition proposal.<sup>35</sup>

Finally, in obiter in the last paragraph of the judgment, French J stated:

I am inclined to the view that assets purchased by a bankrupt with after-acquired income will, if not within any of the excluded categories in s 116(2), constitute property divisible among the creditors and vest in the trustee. In my opinion, however, no final decision should be given on this point which is still rather hypothetical.<sup>36</sup>

This judgment identifies that there is a potential problem of after-acquired income being converted into property and then being subject to vesting, and tenuously links former legislation and case law to the result that property purchased with such income becomes divisible property.

### 3 *Sheahan v O'Brien*<sup>37</sup>

In this case two bankrupts were being pursued for property that they had owned during their bankruptcy and on which they had continued to pay the mortgage. The Magistrate, Raphael FM, noted that it was common ground that the payments made by the bankrupts were made from income. The Magistrate referred to the view expressed by French J in *Gillies* that Division 4B of the Act was a code dealing with after-acquired income of the bankrupt and that income did not vest in the trustee as after-acquired property pursuant to s 58 of the Act. The Magistrate held that in the case of one of the bankrupts, Mrs O'Brien, all the required procedures were complied with and a nil assessment was made. Therefore, to the extent that she can establish she had income left over which was applied to maintain and reduce the mortgage, then that income is not after-acquired property pursuant to s 58.

However, the Magistrate held that:

the translation of this exempt income into an equity in the Medindie property constitutes an after-acquired property which vests in the trustee pursuant to s 58(1)(b) of the Bankruptcy Act and is divisible among the creditors of the bankrupt under s 116(1)(a).

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<sup>34</sup> Ibid [11].

<sup>35</sup> Ibid [11], [12].

<sup>36</sup> Ibid [12].

<sup>37</sup> [2002] FMCA 25.

Raphael FM stated that '[p]roviding that income was kept in specie or used for the purposes of purchasing assets which fall within s 116(2) then it is not divisible but otherwise it would be.' In doing so he was second guessing French J in *Gillies* musing that as property purchased with after-acquired income was not specifically exempted under s 116(2) then it must be divisible.

*B Recent Cases dealing with what constitutes 'income'*

It is not surprising that throughout the history of Australian bankruptcy law there have been a number of cases involving Division 4B of the Act focusing on whether particular money received by the bankrupt (or somewhat controlled by him or her), is income. The three cases that follow amply demonstrate the debate.

*I Inspector General on Bankruptcy v McGushin*<sup>38</sup>

Michael McGushin was a surgeon practising in Kalgoorlie and he operated a medical practice in which he was the only practitioner. He was sued for malpractice and became bankrupt. In McGushin's case the earnings of a proprietary company were being contested as income derived by the bankrupt even though they were not actually received by the bankrupt. The bankrupt held ten of the eleven shares in the company and the trustee was attempting to claim ten elevenths of the net income of the company as assessable income. The bankrupt was already assessed for the income he had received. The company went into liquidation and paid no dividends to shareholders. There was no indication that income was being accumulated or dealt with (e.g., capitalised) on behalf of the bankrupt. Justice McKerracher considered ss 139W, 139L and 139M of the Act and decided that income has to be 'derived' in order to be relevantly assessable and in this case the bankrupt had not derived the income for the purposes of s 139W.<sup>39</sup> The funds received by the company after the payment of net entitlements to its employee were absorbed by the liquidator.<sup>40</sup> McKerracher J also identified the public interest aspect that:

[i]f income does not have to be derived income in order to be relevant assessable, it would mean that all bankrupts employed by a third person or entity should immediately resign after they become bankrupt because whatever money was received by their employer as a result of their labours would constitute their income for the purposes of this division of the Bankruptcy Act.<sup>41</sup>

The judge observed that there was no legislative intention to this effect and that it would produce quite an unexpected outcome.<sup>42</sup> Of course, the shares owned by McGushin vested in the trustee but being shares in an insolvent company, they were of little value.

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<sup>38</sup> [2009] FCA 662.

<sup>39</sup> *Inspector General in Bankruptcy v McGushin* [2009] FCA 662 [44].

<sup>40</sup> *Ibid* [52].

<sup>41</sup> *Ibid* [44].

<sup>42</sup> *Ibid*.

2 *Dominic Lawrence Oliveri and Michael Gregory Jones as Trustee of the Bankrupt Estate of D L Oliveri*<sup>43</sup>

Dominic Oliveri was a solicitor and a bankrupt. His practice was sold and he continued to attend the practice though he was not paid any money.<sup>44</sup> He claimed he spent the rest of the time preparing for his personal litigation and court appearances. The bankrupt's needs were provided for by his personal partner and friends. The bankrupt applied for a review of his trustee's assessment (under s 139L of the Act) of an estimate of reasonable remuneration of \$65,000 per year. DP McMahon in the AAT found that the assessment was made under s 139Y(1) of the Act which permits the trustee to determine that the bankrupt receives reasonable remuneration in respect of employment, work or activities.

The Deputy President heard evidence of the arrangement made with the purchaser of the practice where the new owner would pay the bankrupt \$300 per week, as well as from the principal of a recruitment agency and managing partner of an unrelated law firm to ascertain what a reasonable remuneration would be. There was no industrial award or agreement that prescribed rates or minimum salaries. McMahon DP concluded that:

it is necessary to pay some regard to the circumstances of the bankrupt but the test ultimately is not to determine what the bankrupt would (or even could) have earned. [but] [T]he test to be applied is an objective one, tempered only by such considerations that might render an expectation reasonable.<sup>45</sup>

This was consistent with McMahon DP's decision in *Re Nelson and Inspector General in Bankruptcy*<sup>46</sup> (discussed further below).

3 *In the matter of the bankrupt Estate of John Lawrence Sharpe; Re John Lawrence Sharpe; ex parte Max Christopher Donnelly*<sup>47</sup>

John Sharpe was a bankrupt barrister. At the date of his bankruptcy there were outstanding fees due for work he had done before his bankruptcy and for which he had raised a memorandum of fees. The court was asked to determine whether the barrister's professional fees due to a bankrupt and outstanding at the date of his bankruptcy would constitute income within Division 4B of Part VI of the Act. The Federal Court decided that they would indeed be income and not property that was available to pay creditors.

Lockhart J recognised the two different approaches, that of after-acquired income vesting in the trustee (except to the extent to which they were required for the support

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<sup>43</sup> [1998] AATA 570.

<sup>44</sup> Ibid [12].

<sup>45</sup> Ibid [33].

<sup>46</sup> (1994) 35 ALD 113.

<sup>47</sup> [1998] FCA 6.

of the bankrupt and his family, as found in the UK) and the other approach of leaving the income with the bankrupt unless by statutory intervention some of the money would be paid over to the trustee for the benefit of his or her creditors.<sup>48</sup> He opined that the latter approach seemed a “more logical and sensible view.”<sup>49</sup>

Lockhart J commented on Division 4B of Part VI of the Act:

Although the after-acquired property to which ss 58 and 116 of the Bankruptcy Act apply are sufficiently widely defined to include income of the bankrupt, Division 4B establishes a comprehensive scheme of dealing with after-acquired income of the bankrupt. Where it is inconsistent with sections such as ss 58 and 116, provisions of the division must be taken to apply.<sup>50</sup>

The trustee was held not to be entitled to treat the fees which were the subject of the memoranda of fees issued by the bankrupt (and outstanding at the date of his bankruptcy) as after-acquired property of the bankrupt. Despite such a finding, Lockhart J held that the trustee should treat the memoranda of fees rendered by the bankrupt before the date of his bankruptcy as income derived by the bankrupt after the commencement of his bankruptcy and capable of inclusion in the calculation of income contribution assessments under Division 4B of Part VI of the Act.<sup>51</sup>

*C Converting income to capital –  
UK and NZ perspectives on the question in Rodway v White*

The UK Insolvency Service Technical Manual (‘UK Technical Manual’)<sup>52</sup> addresses the same issue which confronted the court in *Rodway v White* – namely, the treatment of non-divisible proceeds which have been converted to another type of property (eg, a capital asset). Chapter 31.8 of the UK Technical Manual provides ‘general advice and guidance relating to after-acquired property, including an overview of what does, and does not, constitute after-acquired property and the procedure for laying claim to after-acquired property.’<sup>53</sup> Not unlike the Australian position, the UK Technical Manual states that ‘there are certain types of property that would not be claimed as after-acquired property, either for statutory reasons ... , or because the property is more properly classified as income and should, therefore, be claimed under an IPA/IPO’ (ie, an income payments agreement or income payments order).<sup>54</sup> The UK Technical manual states that ‘[w]here damages relating to a personal action are paid to the bankrupt during the period of bankruptcy they may only be claimed as after-

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<sup>48</sup> Ibid 6.

<sup>49</sup> Ibid 6.

<sup>50</sup> Ibid 7.

<sup>51</sup> Ibid 3 and 8.

<sup>52</sup> The *UK Insolvency Service Technical Manual* is available online at *Freedom of Information: The Insolvency Service Publication Scheme* (June 2007) The Insolvency Service, UK <<http://www.insolvencydirect.bis.gov.uk/freedomofinformation/>>.

<sup>53</sup> *UK Insolvency Service Technical Manual*, Ch 31 (Realisation of Assets), Introduction [31.8.1].

<sup>54</sup> Ibid [31.8.32].

acquired property if they were to change character during the period of bankruptcy—for example, if they were invested in property, or used to purchase another asset’.<sup>55</sup> In support of this statement, the UK Technical Manual (which is updated to 13 September 2013) cites a 19<sup>th</sup> century authority, *In re Wilson ex parte Vine*. (‘*Vine’s case*’)<sup>56</sup> *Vine’s case* is also cited in support of another statement in Chapter 31.9 of the UK Technical Manual that ‘[m]onies awarded for “personal” elements of a claim following litigation or secured in a settlement after the making of the bankruptcy order may not be claimed by the official receiver, as trustee, unless those monies change character during the period of bankruptcy’.<sup>57</sup>

As in the UK, in Australia the proceeds of actions (eg, damages) for personal injury or wrong to the bankrupt are non-divisible property under s 116 of the Act.<sup>58</sup> Additionally, the Australian statute goes further in expressly providing that any property acquired with those non-divisible proceeds shall also be non-divisible property.<sup>59</sup> However, as identified above, that provision does not extend to the use of exempt *income*, which leaves property purchased with such income vulnerable to characterisation as after-acquired property and divisible among creditors (as per the construction of the Act adopted by French J (in obiter) in *Re Gillies* and by Heenan J in *Rodway v White*).

The judgment of the English Court of Appeal in *Vine’s case* is brief – the Court rejected the attempt of a trustee to lay claim to proceeds of a judgment obtained by an undischarged bankrupt who had successfully sued for slander. The leading judgment of James LJ (with whom the other members of the Court concurred) held that the trustee was unable ‘to intercept the damages before they reach the bankrupt’s hands, or to prevent him, if he has got them, from spending them in the maintenance of himself and his family.’<sup>60</sup> James LJ stated that:

an exception [to the divisibility of an undischarged bankrupt’s property among all his creditors] was absolutely necessary in order that the bankrupt might not be an outlaw, a mere slave to his trustee; he could not be prevented from earning his own living. On that principle the trustee could not sue for moneys due to the bankrupt in respect of his personal labour, and, if the bankrupt could sue for them only for the benefit of his trustee, he would really be without remedy. If he could not sue for damages in respect of a personal wrong, such as the seduction of his daughter, or anything like that, the Courts of the realm would be closed to him for all practical purposes.<sup>61</sup>

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<sup>55</sup> Ibid [31.8.43].

<sup>56</sup> (1878) LR 8 Ch D 364.

<sup>57</sup> *UK Insolvency Service Technical Manual*, [31.9.196], citing *In re Wilson ex parte Vine* (1878) LR 8 Ch D 364.

<sup>58</sup> *Bankruptcy Act 1966* (Cth) s 116(2)(g).

<sup>59</sup> The combined operation of ss 116(2)(n), 116(2D) and 116(3) of the Act.

<sup>60</sup> *In re Wilson ex parte Vine* (1878) LR 8 Ch D 364, 367 (James LJ).

<sup>61</sup> (1878) LR 8 Ch D 364, 366 (James LJ).

James LJ made a further obiter statement of principle which for all its brevity appears to have demonstrated remarkable resilience during the subsequent 135 years of English bankruptcy law:

If the bankrupt had accumulated the money and had invested it in some property, that property might be reached by the trustee.<sup>62</sup>

The obiter of James LJ in *Vine's case* appears to constitute the kernel of legal principle relating to the 'changed character' of non-divisible proceeds – a doctrine which currently holds sway in the UK and which has its Australian manifestation in the form of the obiter of French J in *Re Gillies* and the decision of Heenan J in *Rodway v White*.

The relevance of *Vine's case* to the question of the effect of a bankrupt's use of exempt proceeds/money to purchase other property was confirmed in the New Zealand case of *Leach v Official Assignee (Leach)*.<sup>63</sup> *Leach* could be said to be the New Zealand equivalent of *Rodway v White* and saw the New Zealand court squarely address *Vine's case*. In *Leach* the trustee had realised property which had been ultimately acquired by the bankrupt through the use of proceeds of a personal injuries claim (for an injury sustained well after the commencement of the bankruptcy). After discharge the former bankrupt sought an order that the trustee account for those realisation proceeds. Not unlike Heenan J in *Rodway v White* twenty-five years later, Cooke J in *Leach* observed that the case 'raises a point of principle which it is odd to find unsettled.'<sup>64</sup> Cooke J set out the issue for determination in much the same terms as that which presented the court in *Rodway v White*:

[I]t is accepted that there is a rule of law preventing the passing to ... [the Assignee] of a right of action for damages for personal injuries suffered by the bankrupt. Likewise it is accepted that the Assignee cannot prevent the bankrupt from spending the proceeds of such an action on the maintenance of himself and his family. And it is even accepted that as long as the damages or the balance of them retain their identity as a fund - for instance, while they remain in a bank deposit account - they cannot be touched by the Assignee. But it is contended that once they are invested, whether prudently or otherwise, and are represented by such property as shares, debentures, land, mortgages or (as here) motorcars, the Assignee is entitled to that property. Reliance is placed on an obiter dictum of James LJ in [*Vine's case*] ...

Interestingly, Cooke J was referred by counsel to some Australian commentary of the day relating to the central point in issue:

[I]n McDonald, Henry and Meek's *Australian Bankruptcy Law and Practice* (4th ed, 1968) para 295, the following is said with regard to *Vine's case*;

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<sup>62</sup> Ibid.

<sup>63</sup> [1975] 1 NZLR 73.

<sup>64</sup> Ibid 84 (Cooke J).

"It has been suggested that a trustee might be able to reach damages recovered for personal injury, if the amount recovered was invested in property. If the damages are clearly earmarked, it is submitted that the trustee cannot reach them even if invested in property."<sup>65</sup>

Cooke J ultimately refused to follow the obiter of James LJ in *Vine's case*. Cooke J's reasons for denying the trustee the property acquired by the bankrupt with exempt proceeds are worth setting out, as they provide some insightful perspectives for an Australian court seeking to correctly construe the Australian statute on this issue:

For the following interrelated reasons I prefer the submission in the Australian textbook to the dictum in *Vine's case*:

- (i) It would seem that the law would be open to the reproach of cynicism if it declared on the one hand that the bankrupt's right of action for damages for a personal tort was no concern of the Assignee in bankruptcy yet on the other that the Assignee might seize the fruits for the benefit of the creditors if the bankrupt was so unwise as to convert the damages into some other form of property.
- (ii) Whatever may have been the position when, as in 1878, money values were relatively constant, it would be unreasonable to deter the bankrupt from a prudent investment intended to preserve the damages against inflation.
- (iii) In the present case and many other cases of damages for personal injuries, the sum recovered is intended to compensate for effects likely to last long beyond the period (now prima facie three years) of the bankruptcy ...
- (v) It is illogical to distinguish between an investment resulting in a chose in action, such as debt due from a banker, and an investment resulting in some other form of property.

Cooke J held that '[t]o prevent an investment passing to the Assignee it would be necessary for it to be identified with the damages' (ie, the originally exempt money or proceeds).<sup>66</sup>

*D An open question of statutory construction – should bankrupts be able to retain property bought with their exempt income or proceeds?*

In so far as context plays a part in the correct interpretation of a statute, Cooke J's approach in the New Zealand case of *Leach* bears some reflection by Australian courts in the construction of Division 4B of Part VI of the Act. As expressed by English courts in the 19<sup>th</sup> century, the gist of the principle (or doctrine) favouring the bankrupt's retention of income was that bankrupts should not become 'slaves' to their trustee or creditors. Should not this same approach be applied in a modern context? According to some financial commentators we are currently living through an era of

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<sup>65</sup> Ibid 86 (Cooke J).

<sup>66</sup> Ibid 88 (Cooke J).



unprecedented (central bank-inspired) ‘financial repression’ effected by monetary policies such as long-term, emergency (low) level interest rates intended to discourage savings in bank accounts and encourage the investment of cash in a ‘chase for yield’. As Cooke J observed in 1974, the value of money in times of inflation (or volatile currency fluctuations such as we have today) is not as constant or certain as perhaps it was in 1878. The fact that a UK Technical Manual in 2013 cites an 1878 case as authority for the inability of a bankrupt to invest exempt money would bemuse many in the general community.

Moving from context and policy to a more technical point of statutory construction, s 139M(1)(b) of the Act would appear to offer an argument in support of the ability of bankrupts to freely convert their exempt income. Section 139M(1)(b) provides that income is taken to be derived by a bankrupt even though it is not actually received by the bankrupt because it is ‘reinvested’ or ‘capitalised’. If *Rodway v White* is correct on the divisibility of income which has changed character to that of an acquired (capital) asset, s 139M(1)(b) would appear to be otiose in respect of ‘reinvested’ and ‘capitalised’ income. If converted income was truly intended to be divisible (as after-acquired property) then the references in s 139M(1)(b) to ‘reinvested’ and ‘capitalised’ income would be altogether unnecessary. The better view may be that Division 4B of Part VI of the Act is intended to be a stand-alone ‘code’ in respect of income *and its investment or appropriation*, such that if income is exempt under the parameters of Division 4B then its investment/appropriation is equally exempt from the rest of the Act (in particular s 116).

*E Sections 139Y and 139ZL: assessment of ‘reasonable’ income and garnishee notices*

Section 139Y enables a trustee in bankruptcy to ‘assess the bankrupt as having an income which is reasonable in light of the actual work or activities carried out by the bankrupt.’<sup>67</sup> Section 139Y of the Act can be a difficult provision to rationalise in terms of its possible outcomes. This might be partly explained by the fact that the Explanatory Memorandum to the Bankruptcy Amendment Bill 1991 (which established the income contributions regime in Division 4B) appears to sit at odds with the precise terms of s 139Y:

Some bankrupts *claim* not to be in receipt of income, or indeed to be unemployed, but their lifestyle and activities are quite inconsistent with such *claims*. Usually in such circumstances, all the income generated by the bankrupt’s activities is channelled into another entity ... Proposed subsection 139Y(1) is directed principally to a situation where the bankrupt *claims* either that he or she generated a low income from work which might otherwise be expected to generate a higher income, or that he or she is

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<sup>67</sup> Bankruptcy Amendment Bill 1991, Explanatory Memorandum, 86 [25.43].

unemployed, *but in fact* carries out activities which resemble work and from which income is generated<sup>68</sup> (emphasis added).

However, the terms of s 139Y are clear that the provision applies if the bankrupt is engaging in work and *actually* receives remuneration that is less than 'reasonable remuneration'. Section 139Y is not limited to the situation where a bankrupt *claims* to be receiving less than reasonable remuneration and the trustee has reasonable grounds to believe otherwise.<sup>69</sup>

*Pattison v Schiffer*<sup>70</sup> demonstrates the application of s 139Y in the scenario of a bankrupt earning income while 'employed' by his trading corporate alter egos.<sup>71</sup> In *Pattison* the trustee issued a standard notice of contribution upon the bankrupt under s 139ZG. Could the trustee have issued a s 139ZL 'garnishee notice' upon the bankrupt's employer companies? It appears that the Official Receiver cannot issue an income contribution 'garnishee notice' under ss 139ZK and 139ZL of the Act unless there is an 'identifiable sum of money owing'.<sup>72</sup>

Another notable case of a disputed s 139Y assessment is *Re Nelson and Inspector-General in Bankruptcy (Nelson)*.<sup>73</sup> In that case, the bankrupt (a former lawyer who had been struck off for disciplinary reasons) was employed in the limited capacity of a law clerk with his wife's legal practice.<sup>74</sup> The relationship of the bankrupt and his employer caused the trustee in bankruptcy to form the view 'that the applicant was receiving remuneration that was less than might reasonably be expected to be, or to have been, received by a person who engaged in similar employment where there was no relationship between that person and his or her employer.'<sup>75</sup> The bankrupt received a gross salary of \$21,600 but was assessed for the amount of \$35,000 per year.<sup>76</sup> Ultimately, the Administrative Appeals Tribunal set aside the assessment on the basis that 'the best evidence of what might reasonably be expected to be received by a person carrying out ... [the bankrupt's] duties with ... [the bankrupt's]

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<sup>68</sup> Ibid [25.43]-[25.44].

<sup>69</sup> Unlike s 139Z, which applies where a bankrupt claims not to be likely to derive, or not to have derived, any income during an assessment period. In that case, s 139Z empowers the trustee to determine that the bankrupt did derive income and also determine the amount of that income.

<sup>70</sup> [2007] FMCA 319.

<sup>71</sup> In *Pattison v Schiffer* the bankrupt worked in a role which was most closely analogous to that of a 'chief engineering executive' with numerous trading companies. The bankrupt had also continued to act as a director of those companies, in breach of his obligations.

<sup>72</sup> *Re Bond; Ex Parte Bond v Caddy* (No.1) (1994) 115 FLR 152 (Seaman J). The Subdivision I garnishee provisions are said to be based upon s 218 of the *Income Tax Assessment Act* (Cth).

<sup>73</sup> (1994) 35 ALD 113.

<sup>74</sup> The Supreme Court of the ACT (on appeal) had permitted the bankrupt to be employed as a law clerk with his wife's practice, subject to strict conditions.

<sup>75</sup> *Re Nelson and Inspector-General in Bankruptcy* (1994) 35 ALD 113, 116 (14) (Dep Pres McMahan)

<sup>76</sup> Ibid.

background is what ... [the bankrupt] now receives.’<sup>77</sup> Like *Pattison*, *Nelson* involved asserted delay and failure on the part of the bankrupt to provide to the trustee information about the bankrupt’s property, income or expected income.

While the parallels of *Pattison* and *Nelson* are obvious (ie, bankrupts working for a related party), both cases highlight the curiosity of a s 139Y assessment – that is, that a bankrupt who is actually receiving \$  $x$  of income can be assessed by a trustee-in-bankruptcy to have received \$  $x+y$  in income. Both cases beg the question: from what resources was the bankrupt supposed to meet the ultimate liability for the contribution (as notified under s 139ZI)? Under s 139Y, the bankrupt is rendered liable to contribute a share of his/her income which both the bankrupt and the trustee agree was never actually earned or received. In *Pattison*, was it the trustee’s expectation that the bankrupt would cause his corporate alter egos to stump up the cash required to meet the contribution notice?<sup>78</sup> In *Nelson*, was it the trustee’s expectation that upon receipt of the contribution notice the bankrupt law clerk would confront his employer wife and ask for a raise? (Such a scenario might produce another novel example of the possible interaction of bankruptcy law and family law!)

Assuming the trustees in both cases made their s 139Y assessments on the basis that there was ‘real money’ somewhere behind the bankrupt (or the bankrupt’s employment), one might reflect upon whether it is the employer who should be the logical recipient of any contribution notice in circumstances where the bankrupt is providing services for a lesser amount of remuneration than is considered reasonable. How do the garnishee provisions of Division 4B of Part VI the Act sit with the ability of trustees to make a s 139Y assessment of income which was not ever actually received? This is explored further below in a practical scenario.

Would a garnishee notice be available (or competent) in respect of the quantum meruit claim of a bankrupt who has not received payment of a reasonable amount for his/her services? In *Edwards v Australian Securities and Investments Commission*<sup>79</sup> the New South Wales Court of Appeal held that a quantum meruit claim for the reasonable value of work done upon request is a ‘debt’ for the purposes of s 588G of the *Corporations Act 2001* (Cth). The court identified a ‘wealth of authority for the proposition that a claim for the reasonable value of work done, enforceable by a quantum meruit action, is a “debt or liquidated demand” for the purposes of court rules conferring procedural advantages on persons suing for debts or making demands for liquidated amounts’.<sup>80</sup> However, if a bankrupt agrees to work for an

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<sup>77</sup> Ibid 118 (22). The Tribunal also held that the assessment should have taken into account the value of the use of the bankrupt wife’s motor vehicle and her provision of rent-free accommodation.

<sup>78</sup> In *Pattison* it seems that there was ‘real money’ behind the bankrupt in light of the various companies he was managing. It may have been that the bankrupt had an interest in avoiding a prolonged bankruptcy and so would be likely to find the resources to meet the contribution notice based on the s 139Y assessment.

<sup>79</sup> (2009) 264 ALR 723.

<sup>80</sup> *Edwards v Australian Securities and Investments Commission* (2009) 264 ALR 723, [81] (Macfarlan JA).

employer for a 'below-market' wage, it would seem unlikely that a trustee-in-bankruptcy can somehow step into the shoes of the bankrupt and effectively compel the employer to pay a certain level of remuneration. (Query whether the position might be different if the employment relationship was governed by legislative minimum standards or an award.) Should the Act be amended to allow a *primary* contribution notice to be served upon an employer who is receiving the benefit of cheap or discounted labour?

VII CAN PAY, SHOULD PAY, MAKING THEM PAY  
(BUT AVOIDING SLAVERY)

A *A few possible scenarios*

So far the discussion has featured the primary sources of income contribution law, the case law and legislation which provide that, while undischarged, a bankrupt who has income will need to make a contribution to his or her creditors. It is a system designed so that those who can pay should pay. It is then designed to make them pay. The following practical scenarios demonstrate that while a bankrupt remains under the relevant threshold he/she is treated fairly under Division 4B of Part VI of the Act. However, once over the threshold a bankrupt could be required to hand over 'after-acquired property' as well as make income contributions, whilst a bankrupt in an identical position would only be required to make income contributions because of their choice of what they do with excess money. The final scenario considers the notion of garnisheeing an income contribution from non-existent income.

1 *Scenario One*

Bruce, despite being an undischarged bankrupt, is a frugal man, who works as a suburban bus driver and is paid \$19 per hour for a 35 hour week (\$34,550). On about 40 weekends per year he works as a chauffeur and is paid \$30 per hour for 10 weekend hours. This averages \$12,000 per year. His assessed income is \$46,550. He pays \$250 per week rent. He has no dependants.

Bruce would make no income contribution and as he has no money over the threshold he is not effected by any loss. In this scenario the application of the legislation appears to be fair. Bruce is not expected to pay his creditors an income contribution so the 'can pay, should pay' approach is workable.

2 *Scenario Two*

Cheryl is an undischarged bankrupt and is a frugal woman. She is employed as a payroll supervisor and is paid \$65,785. She has no dependents. Under s 139K of the Act, her BITA limit is \$52,543.50 which is also hers AITA.<sup>81</sup> Under s 139S of the Act the amount of income contributions to be paid is \$6,620.75.<sup>82</sup> She pays \$250 per week rent.

In the year after Cheryl was made bankrupt she paid her income contribution. During that year she put aside a little money each week and accumulated \$5000. With this money she had saved in a tin at home she buys some listed 'Q' shares from an on-line broker. Her trustee takes the shares as after-acquired property on the basis of the

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<sup>81</sup> See above n 9.

<sup>82</sup> Calculated under s 139S of the Act as half of the difference between 'Assessed income' (\$65,785) and the AITA (\$52,543.50) – ie, half of \$13,241.50.

present law emanating from *Rodway v White* in conjunction with the Bankruptcy Act.. He tells her she is lucky he is not pursuing her for Bankruptcy Act offences. Cheryl decides not to save any more money.

### 3 *Scenario Three*

Athol is an undischarged bankrupt and is a frugal man. He, too is employed as a payroll supervisor and is paid \$65,785. He has no dependents. Under s 139K of the Act, his BITA limit is \$52,543.40 which is also his AITA. Under s 139S of the Act, the amount of income contributions to be paid is \$6,620.75.<sup>83</sup> He pays \$250 per week rent

In each of his three years of bankruptcy Athol pays his income contribution. Additionally, in each year that he is bankrupt he puts aside a little money each week and it accumulates to \$5,000 per year. He puts it in a tin under his bed. After being discharged he takes the \$15,000 out of his tin and buys listed 'Q' shares from an online broker. He does not disclose this to his trustee. Under the present law Athol keeps the money while being bankrupt and is permitted 'post-bankruptcy' to convert cash into shares. His scenario is identical to Cheryl's apart from her mistake to convert cash to shares during her bankruptcy, a move that produces an unfair result between two bankrupts who have both paid the income contribution that the Act requires of them.

### 4 *Scenario Four*

Ahmed is an undischarged bankrupt. On the application of a bank, a sequestration order was made against Ahmed. The Official Trustee was appointed as the trustee for Ahmed's estate. During investigations into Ahmed's affairs, it came to light that Ahmed's net annual income as declared in his statement of affairs was \$32,500. However, for the last eight months Ahmed has been employed as a finance officer at a medium-sized grocery distributor, on a full-time basis. Ahmed explained that he is still 'learning the ropes', and his cousin Mohammed gave him the job out of family loyalty after the financial collapse of Ahmed's previous employer. Finance officers in similar-sized businesses are normally paid around \$65,000 (after tax) annually.

Can the Official Receiver provide Mohammed with a s 139ZL 'garnishee notice' on the basis of an assessment of Ahmed's 'reasonable' level of income under s 139Y?

A 'reasonable remuneration assessment' and 'garnishee notice' could operate together in a scenario where the bankrupt is receiving less than what is considered reasonable for his/her work. In scenario 4 above, Ahmed's income could be assessed under s 139Y for the purposes of arriving at an ultimate contribution liability which is not - according to the Act's own thresholds - appropriate for the amount of wages he *actually* receives each week. The debt obligation of Mohammed to pay Ahmed's

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<sup>83</sup> Ibid.

inadequate salary (whatever it is) could legitimately be the subject of a garnishee notice under s 139ZL in respect of Ahmed's contribution liability calculated on the basis of a s 139Y assessment. This would appear to be a harsh outcome for Ahmed in that his wages are garnisheed by reference to an assessed level of remuneration which he never actually enjoys. Ahmed might ask Mohammed for a raise but Mohammed may, of course, reject such a request. It would be interesting to know if any of these considerations are (or should be) relevant to the exercise of the trustee's discretion to make a s 139Y assessment.

### *B Voluntary contributions*

Section 139P(2) of the Act provides that if the income during the assessment period is 'under the original assessment' and not exceeding the actual income threshold amount then the bankrupt 'may if he or she so wishes' pay to the trustee a contribution. There is limited information available about this voluntary contribution. It was inserted into the Act in 1992. Presumably, the provision was placed in the Act to cater for those bankrupts who feel that they have a moral obligation to pay their debts, despite their bankrupt status.

Four questions are worth pursuing;

- How much is collected for distribution to creditors from voluntary contributions and how much of the amount collected actually is distributed?
- Since its introduction have there been any behavioural changes to suggest that bankrupts in 2014 are more or less inclined to make voluntary contributions?
- What is the motivation for those bankrupts who do make a voluntary contribution? What profiles do such bankrupts exhibit?
- Should the voluntary contribution mechanism exist or continue in its current form?

At present these questions remain un-researched and therefore unanswered.

### *C Calculating the contribution payable by the bankrupt*

Section 139S of the Act provides a formula for the contribution that a bankrupt is liable to pay in respect of a contribution assessment period. The Act uses two important phrases: 'Assessed income' and 'Actual income threshold amount'. Do these phrases and the formula work?

#### *1 A sliding scale*

The income assessment calculation which incorporates dependents could be further refined to address both the creditors' interests in receiving more from the bankrupt's income and the bankrupt's interests in having an incentive to work and recover

financially, by introducing a sliding scale much like the progressive, marginal income tax system. While the 'flat rate' of 50% in the current s 139S formula applies regardless of the size of the income, other percentage rates could apply for higher incomes. For example, consideration could be given to bankrupts whose incomes exceed twice the threshold (ie, incomes of more than \$105,086.80) being required to pay a higher contribution rate of, say, 55% and those whose incomes are at three times the threshold (ie, \$157,630.20) contributing at an even higher rate of 60%.

## 2 *Compensation for lack of homestead exemption*

When a bankrupt has to pay rent or a mortgage because there is no home exemption then should an adjustment be made for their contribution? Section 139T of the Act permits bankrupts to apply in writing if they are living in rented accommodation for a determination that may alleviate such hardship. Perhaps a discount could be factored in for any mortgage a bankrupt pays before contribution. Perhaps the rent a bankrupt pays could be 'automatically' assessed rather than requiring a determination. Assessed income could be reduced by the average rental payable for the capital city nearest to the bankrupt. Currently, rents are mostly cheaper in country areas which means that bankrupts who live in those areas have more to live on compared with 'city bankrupts' who have to pay higher rent (or mortgage instalments) and also make their required contribution. Arguably though, the costs of travel and food may be higher in country areas which might offset the cheaper 'shelter' costs.

The consideration of shelter expenses is relevant given that house mortgage payments do not feature in income tax assessment. Section 139N of the Act permits the assessed income to be reduced by amounts payable in respect of income tax. Again, it would seem to address the goal of fairness if city and country bankrupts were treated according to their circumstances for housing as it is such a large expense.

## 3 *Is the base solid?*

The basic income threshold amount ('BITA') is increased by the number of dependants to provide the actual income threshold amount ('AITA'). This is defined in s 139K. Should there be other factors beyond the number of dependants which require an adjustment to the BITA? At present the BITA is '3.5 times the amount that, at that time, is specified in column 3, item 2, Table B, point 1064-B1, Pension Rate Calculator A in the Social Security Act 1991'. BITA is therefore linked to the *Social Security Act 1991* (Cth) but should it be closer linked to other indicators such as the minimum wage?

## D *Fixing the Rodway v White outcome*

The most obvious solution to the inappropriate situation of having law which is not readily understood and 'accessible' would be to have s 116(2) of the Act expressly provide that all property purchased with after-acquired income becomes 'exempt'. This would be an expansion of the current concept of exempting property purchased with 'protected money' within the terms of ss 116(2D) and 116(2)(n) of the Act.



Alternatively, the legislation could identify what is exempt from becoming ‘after-acquired property’. For example, it could expressly exempt shares, making them exempt property under s 116(2) (or Reg 6.03A) if they were purchased with after-acquired income beyond the contribution thresholds. The legislation could even add an extra dimension to the meaning of ‘income’ - as provided by s 139L(1) - to include the proceeds of dividends from shares purchased with after-acquired income beyond the threshold. The meaning of ‘exempt property’ could be expanded to include in the threshold voluntary mortgage payments made during the bankruptcy, albeit, after the income contribution has been paid. Again, the terms of s 116(2)(v) - which provides that ‘the amount of money a bankrupt holds in an RSA’ is not divisible among creditors - could be extended to ‘amounts added to these accounts from after-acquired income beyond the contribution threshold’. There may be other items of property which could also rate an express mention in an amended s 116(2). These legislative changes would avoid any further development (or argument) of the jurisprudence commenced in *Rodway v White* where Heenan J introduced the requirement of exploring whether the after-acquired income had become ‘distinctively different’.<sup>84</sup>

If it is viewed that after-acquired income beyond the contribution threshold is best moved to the estate to distribute to creditors, then this could be legislated for by allowing a resolution of creditors on the matter. In the same vein as ss 116(2)(b), (ba) and (c) of the Act which permit the bankrupt to retain certain (prescribed) property identified by a resolution of creditors, investment purchases from after-acquired income could be subjected to similar treatment.

## VIII CONCLUSION

Contribution from a bankrupt’s income towards the creditors is a sound idea. For 22 years Australia has permitted trustees to make an assessment and required bankrupts to contribute without the court directing the amount. Creditors have benefited from such legislation and its accompanying jurisprudence. The history and theoretical framework is informative and the current statistics suggest it is workable law. This article has identified potential areas of further enquiry to assure stakeholders that what presently exists is not only efficient but also just.

Compelling bankrupts to make income contribution can be seen as a punishment. Some bankrupts will continue to be employed and should be encouraged for ‘good’, responsible behaviour. Therefore, legislation must be fair and balanced so that such bankrupts have no reason to complain and/or choose to work less to avoid paying half of their earnings to their creditors.

The notions of ‘after-acquired’ income and property and ‘converted income’ need further clarification to avoid the *Rodway v White* situation and provide certainty for bankrupts. Bankrupts need clarity on what is required to be disclosed from monies

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<sup>84</sup> *Rodway v White* [2009] WASC 201, [66].

that they have which are surplus to the contribution assessment. The potential for a repeat of the ‘triple penalty’ on industrious, frugal bankrupts – ie, where they pay an income contribution, lose property purchased from after-acquired income which is otherwise beyond the contribution threshold, and commit offences for non-disclosure of property - must be removed.

One final reflection: in Kenya discharged bankrupts have to lodge a report 12 months *after* discharge showing their property and income situation so that there can be a review of property acquired subsequent to discharge.<sup>85</sup> In such a regime even Athol, [in Scenario Three above] would be subject to losing his recently acquired, post-bankruptcy shares!

The success of Division 4B of Part VI of the Act is critical to Australian bankruptcy law striking the right balance of avoiding the economic and financial repression of bankrupts while also recognising legitimate community expectations of reciprocal responsibility – ie, that income-earning bankrupts should make a reasonable contribution to their creditors as a *quid pro quo* for their financial ‘clean slate’ or fresh start. For that reason, a critical review and refinement of Australia’s income contribution regime for bankrupts is timely.

#### POSTSCRIPT

Just prior to going to press, the authors noted with interest a July 2014 Federal Court decision which addressed some of the very issues canvassed above. In *Di Cioccio v Official Trustee in Bankruptcy* [2014] FCA 782 Pagone J had to determine whether shares purchased by a bankrupt were ‘after-acquired property’ when the shares were purchased with savings from income which fell below the threshold amount for contributions. In short, Pagone J held that there was ‘not a sufficient reason to depart from the view expressed in *Re Gillies* and applied in *Rodway v White*.’ However, his Honour did observe that the outcome for the bankrupt ‘may seem harsh’ and that the prevailing construction of the relevant provisions of the statute ‘may appear to operate in tension with the policy in Division 4B.’ In the authors’ view, Pagone J’s judgment reinforces the need for clarification of the situation by legislative amendment.

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<sup>85</sup> The Bankruptcy Act 2009 (Kenya) s 195.