

# **CAN THE TRUSTEE IN BANKRUPTCY EVER WIN?**

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Dealing with debts is often more difficult than dealing with real property and cash. Are liabilities deducted from the assets to calculate the net pool? Should one party take more responsibility for a debt or debts than the other party?

Dealing with bankruptcy adds extra layers of complexity. What does a family lawyer need to know about bankruptcy law? Will the bankrupt or the trustee in bankruptcy be a party to the proceedings? Will both be parties? How does the *Family Law Act* apply? How are the conflicting rights of a non-bankrupt spouse, the bankrupt and the trustee in bankruptcy resolved?

The *Bankruptcy Act 1966* ("BA") and the *Family Law Act 1975* ("FLA") are very different pieces of legislation with different objectives. The BA distributes property and income between the creditors of a person unable to pay their debts. The FLA distributes the property of separated spouses usually between separated spouses, but sometimes to third parties such as children and creditors. Before 2005, different Courts exercised jurisdiction under each Act. The rights of the parties were resolved separately in separate disputes. Often the person who won was the one whose claim was resolved first. Sometimes under the FLA, creditors sought priority over the non-debtor spouse on the basis of "the roller coaster principle," meaning that in a marriage partnership, parties had to share in the bad times as well as the good times. The non-debtor spouse should accept some responsibility for debts incurred in the other spouse's name particularly business debts and tax liabilities as, during the relationship, the non-debtor spouse has received lifestyle benefits and may have accrued assets from the non-debtor's income.

The *Bankruptcy and Family Law Legislation Amendment Act 2005* ("the 2005 Act") introduced a new way to resolve disputes about the property of a bankrupt when a bankrupt is separated. These disputes are now dealt in the one court, by the Family Court. The Federal Magistrates Court retains its dual jurisdiction under both Acts.

The solution was ostensibly simple, but as the 2005 Act did not give clear direction to the Courts as to how they should resolve these disputes, there has been a long period of uncertainty. There are now sufficient cases to give clearer, but not definitive, advice as to the range of possible outcomes.

In this paper, the sections of the FLA which apply to de facto couples are not stated but, if de facto couples are under the FLA, there are equivalent sections applicable.

## Overview of bankruptcy law

Upon bankruptcy, property owned by the bankrupt as at the date of the bankruptcy vests in the trustee in bankruptcy (s 58 *BA*). However, some property is exempt under s 116 *BA* including:

- superannuation - s 116(2)(d) *BA*. Payments into superannuation made to defeat creditors can, however, be clawed back under s 128B and 128C *BA*
- most household goods - s 116(2)(b))
- equity in motor vehicles of up to \$6,700 - s 116(2)(ca) *BA*. This amount is indexed.
- tools of trade worth up to \$3,350 - s 116(2)(c) *BA*. This amount is indexed
- property held by the bankrupt on trust -s 116(2)(a) *BA*

The bankruptcy may be deemed to have commenced before the date of bankruptcy - perhaps 6 months or more prior. This means transfers of property made prior to the bankruptcy by a spouse who is later bankrupted to a non-bankrupt spouse, may be property of the bankrupt under s 58(1) *BA*.

Transfers of property (including transfers pursuant to court orders or financial agreements) may be set aside under the claw back provisions, particularly:

- s 120(1) *BA* - transfers by the bankrupt are void against the trustee if made within 5 years of the start of the bankruptcy if there was no consideration or it was for less than market value. The phrase "market value" replaced "valuable consideration" in 1996 and it is a far more difficult test
- s 120(3) *BA* - transfers are not void against the trustee if they were made more than 2 years before the start of the bankruptcy and the transferee proves that at the time of the transfer, the transferor was solvent
- s 120(5) *BA* - market value consideration does not include family relationship, marriage or defacto relationship, promise to marry or partner and love or affection

- s 121 *BA* - transfers are void if the main purpose was to defeat creditors (s 121(1)(b) *BA*). A purpose is the main purpose under s 121(1)(b) if it can reasonably be inferred from all the circumstances that, at the time of the transfer, the transferor was, or was about to become insolvent (s 121(2) *BA*)
- s 122(1) *BA* - a transfer of property by a person who is insolvent in favour of a creditor is void against the trustee in the debtor's bankruptcy if the transfer:
  - had the effect of giving the creditor a preference, priority or advantage over other creditors; and
  - was made within a certain period, usually 6 months before the bankruptcy commenced
- s 128B and 128C *BA* - superannuation contributions made on or after 28 July 2006 may be clawed back if the contributions were intended to defeat creditors

Another important provision of the *BA* which is commonly referred to in disputes between the trustee in bankruptcy, the bankrupt and non-bankrupt spouse is s 153B *BA*. This provides that a court may annul a bankruptcy if satisfied that a sequestration order ought not have been made. In practice, if the bankrupt repays all the debts and interest, the trustee's fees and expenses, the bankrupt will obtain an annulment.

### **The position before 2005**

Before the 2005 Act commenced, a non-bankrupt spouse could not make a claim under s 79 *FLA* against property which had vested in the trustee under s 58 *BA*. Various courts struggled to resolve disputes between a non-bankrupt spouse and a trustee in bankruptcy about a bankrupt's property. Sometimes the non-bankrupt spouse was able to make a claim under the *BA*, usually by claiming that property was held on trust by the bankrupt for the non-bankrupt spouse under s 116(2)(a) and it had not vested in the trustee. Direct financial contributions were given great weight to establish that property was held on a constructive trust and therefore exempt under the *BA*, but non-financial contributions, such as homemaking and parenting, usually received less weight (*Baumgartner v Baumgartner* (1987) 164 CLR 137). Non-bankrupt spouses did better under the *FLA* because their claims took into account future needs and other factors under s 75(2) *FLA*. They frequently did not make claims at all under the

BA because of legal costs, the riskiness of the claim and their unfamiliarity with lawyers, bankruptcy and courts.

Although often supportive of the interests of trustees and creditors, the Federal Court at times tried to protect the interests of the non-bankrupt spouse by recognising the value of non-financial contributions. The main cases in which the Federal Court took this approach were *Official Trustee in Bankruptcy v Mateo* (2003) FLC 93-128 and *Official Trustee in Bankruptcy v Lopatinsky* (2003) FLC 93-149. In both cases, the Full Court of the Federal Court relied on equitable principles. In *Mateo*, the Federal Court found that homemaking and parenting contributions were relevant when determining whether the consideration for a transfer was at market value. In *Lopatinsky*, the Full Court of the Federal Court found that the wife's homemaking and parenting contributions under s 79 could not be used to establish her interest as the beneficiary of a trust. Her interest had to be assessed on equitable principles.

An interesting development in the rights of non-bankrupt spouses as against the trustee in bankruptcy occurred in the High Court case of *The Trustees of the Property of John Daniel Cummins v Cummins* [2006] HCA 6. The trustee in *Cummins* did much better than might previously have been expected. This decision was handed down on 7 March 2006 and dealt with the law prior to the 2005 Act, but the principles appear to be unchanged by the 2005 Act.

In *Cummins*, the bankrupt and his wife purchased vacant land as joint tenants in 1970. The bankrupt paid one-quarter of the purchase price and his wife paid the balance. They built a house on the land using joint funds and jointly borrowed funds. In 1987 the bankrupt transferred his half interest in the home to the wife. She paid stamp duty on the transfer but did not pay the monetary consideration stated on the transfer. The bankrupt was a barrister who did not lodge tax returns for about 40 years. His tax liability in 2000 was almost one million dollars. He became bankrupt in December 2000. The trustee in bankruptcy was successful before a single Judge of the Federal Court, unsuccessful before the Full Court of the Federal Court and successful in the High Court.

The High Court found that in a traditional marriage it is often “a purely accidental circumstance” whether money is contributed by a party to the purchase of the home or to living expenses. It concluded that in 1987 the wife’s beneficial interest in the home did not exceed her legal interest before the transfer of the extra 50%. Even after the legal transfer, her beneficial interest remained at 50%. The trustee was, therefore, entitled to 50% of the equity in the home. The High Court also found in favour of the trustee on the alternative ground of a s 121 BA clawback.

## The 2005 Amendments

The 2005 Act gave the Family Court power to make s 79 *FLA* orders about property which has vested in a trustee in bankruptcy if there are property settlement proceedings related to that property. The court can order that property, otherwise available for distribution to creditors, be transferred to the non-bankrupt spouse.

The general rule under the *BA* that property vests in the trustee at the date of bankruptcy (s 58 *BA*) is now subject to property settlement and spousal maintenance orders (s 59A *BA*). A new form of exempt property was added. Section 116(2)(q) *BA* provides that property of the bankrupt is exempt if, under a Pt VIII *FLA* order, the trustee is required to transfer that property to the spouse of the bankrupt. Section 116(2)(r) refers to orders under Pt VIIIAB.

Since the 2005 Act, at the third step of the four step s 79 process, the interests of creditors are considered as one of the factors under s 75(2) (s 75(2)(ha)).

The trustee in bankruptcy is not automatically a party to property settlement proceedings. A trustee must be joined as a party, if the trustee applies to be joined, and if:

- either when the application was made, the party was a bankrupt or after the application was made but before it is finally determined, the party becomes a bankrupt; and
- the Court is satisfied that the interests of the bankrupt's creditors may be affected by the making of a property settlement order (s 79(11) *FLA*)

A bankrupt loses the right to make submissions regarding vested bankruptcy property if a trustee in bankruptcy is a party to property settlement proceedings. The bankrupt must then seek the leave of the court (s 79(12) *FLA*). Leave can only be granted in exceptional circumstances (s 79(13) *FLA*). The bankrupt can, however, as of right, make submissions about property which has not vested, such as superannuation. These submissions may indirectly deal with vested property.

In *Reua and Reua* [2008] FamCA 1038 Stevenson J found that there were "exceptional circumstances" because:

1. There was no opposition to the granting of leave by the wife and the trustee in bankruptcy

2. The husband sought relief in respect of non-vested property so he was a participant in the proceedings anyway
3. The husband had knowledge of the circumstances in which many of the unsecured debts were incurred

None of these seem to be "exceptional" circumstances in the sense otherwise used in the *FLA* (eg. s 79A(1)(d)) relating to changes in arrangements for children.

The non-bankrupt spouse can bring s 79 *FLA* proceedings, as can the bankrupt. A s 79 *FLA* application is a right *in personam* (*Page and Page* (No 2) (1982) FLC 91-241; *Reed and Reed*; *Grellman (Intervener)* (1990) FLC 92-105; *Audet v Audet*; *Official Trustee in Bankruptcy (Intervener)* (1995) FLC 92-607). Any property transferred or paid to the bankrupt will vest in the trustee as after-acquired property (s 58(1)(b) *BA*), subject to the exempt property provisions. A superannuation split is, for example, exempt under s 116(2)(d)(iva) *BA*.

There are very few cases where a bankrupt who wants to be heard will not be heard at least with respect to some aspects of the dispute. The involvement of the non-bankrupt spouse may result in extra costs for the bankrupt spouse. There may be three parties or more, and the bankrupt is usually unrepresented thus increasing the length of hearings and making negotiated settlement on interim and final matters less likely. For example, in *Petrusca* the bankrupt was ordered to file responding material and sought adjournments seeking further time to comply.

The 2005 Act is often seen as disadvantageous to the trustee. The trustee cannot bring a s 79 *FLA* application as a means of trying to enlarge the assets in the bankrupt estate available for creditors. The trustee is almost always responding to an application by a non-bankrupt spouse. Usually, it is unable to improve its position. To protect or improve its position the trustee may try to:

- have the bankrupt's debts paid from the total property pool prior to interests being adjusted between the non-bankrupt spouse and the trustee
- retain the property which was owned by the bankrupt at the date of the bankruptcy and vested in the trustee upon the bankruptcy

- have the bankrupt's superannuation split so that the non-bankrupt spouse takes a greater share of non-exempt assets and more property is available to pay creditors
- try to have a transaction set aside under s 106B(1) or 106B(1A)

A case in which the trustee improved its position was *Reua and Reua*. Before the trial commenced each of the trustee and the wife held property of about \$320,000. The husband's unsecured creditors were over \$230,000 and there were contingent unsecured creditors claiming about \$850,000. The wife sought to retain all the assets vested in the trustee. The husband sought an equal division of non-vested property between himself and the wife. The trustee would then pay unsecured creditors from the husband's share. The trustee sought that the wife and the trustee each retain the property they currently owned. Stevenson J ordered a 65%/35% split and that the wife pay the husband the sum of \$118,892.

A trustee can also use either s 35 or 35A *BA* to try to improve its position. These sections provide:

*Section 35 - Family Court's jurisdiction in bankruptcy where trustee is a party to a property settlement or spousal maintenance proceedings etc*

- (1) If, at a particular time
- (a) a party to a marriage is a bankrupt; and
  - (b) the trustee of the bankrupt's estate is:
    - (i) a party to property settlement proceedings in relation to either or both of the parties to the marriage; or
    - (ii) an applicant under section 79A of the *Family Law Act 1975* for the variation or setting aside of an order made under section 79 of that Act in property settlement proceedings in relation to either or both of the parties to the marriage;
    - (iii) a party to spousal maintenance proceedings in relation to the maintenance of a party to the marriage;

then, at and after that time, the Family Court has jurisdiction in bankruptcy in relation to any matter connected with, or arising out of, the bankruptcy of the bankrupt.

- (1A) If, at a particular time:
- (a) a party to a de facto relationship is a bankrupt; and
  - (b) the trustee of the bankrupt's estate is:
    - (i) a party to property settlement proceedings in relation to either or both of the parties to the de facto relationship; or
    - (ii) an applicant under section 90SN of the *Family Law Act 1975* for the variation or setting aside of an order made under section 90SM of that Act in property settlement proceedings in relation to either or both of the parties to the de facto relationship; or
    - (iii) a party to maintenance proceedings under Part VIIIAB of the *Family Law Act 1975* in relation to the maintenance of one of the parties to the de facto relationship;

then, at and after that time, the Family Court has jurisdiction in bankruptcy in relation to any matter connected with, or arising out of, the bankruptcy of the bankrupt.

- (2) Subsections (1) and (1A) do not limit the Family Court's jurisdiction under section 35A.
- (3) In this section:
  - "property settlement proceedings"** has the same meaning as in the *Family Law Act 1975* .
  - "spousal maintenance proceedings"** means proceedings under the *Family Law Act 1975* with respect to the maintenance of a party to a marriage.
- (4) An expression used in subsection (1A) that is also used in the *Family Law Act 1975* has the same meaning in that subsection as it has in that Act.

#### Section 35A - *Transfer of proceedings to Family Court*

- (1) Subject to subsection (2), where a proceeding is pending in the Federal Court, the Federal Court may, on the application of a party to the proceeding or of its own motion, transfer the proceeding to the Family Court.
- (2) A proceeding that is pending in the Federal Court at the commencement of this section shall not be transferred to the Family Court unless the parties to the proceeding consent to the transfer.
- (2A) If a proceeding is pending in the Federal Magistrates Court, the Federal Magistrates Court may, on the application of a party to the proceeding or on its own initiative, transfer the proceeding to the Family Court.
- (3) Subject to subsection (4), where a proceeding is transferred to the Family Court
  - (a) the Family Court has jurisdiction to hear and determine the proceeding;
  - (b) the Family Court also has jurisdiction to hear and determine matters not otherwise within its jurisdiction (whether by virtue of paragraph (a) or otherwise);
    - (i) that are associated with matters arising in the proceeding;
    - (ii) that, apart from subsection 32(1) of the *Federal Court of Australia Act 1976* , the Federal Court would have had jurisdiction to hear and determine in the proceeding
  - (c) the Family Court may, in and in relation to the proceeding
    - (i) grant such remedies;
    - (ii) make orders of such kinds; and
    - (iii) issue, and direct the issue of, writs of such kinds;
 as the Federal Court could have granted, made, issued or directed the issue of, as the case may be, in and in relation to the proceeding;
  - (d) remedies, orders and writs granted, made or issued by the Family Court in and in relation to the proceeding have effect, and may be enforced by the Family Court, as if they had been granted, made or issued by the Federal Court;
  - (e) appeals lie from judgments of the Family Court given in and in relation to the proceeding as if the judgments were judgments of the Federal Court constituted by a single Judge, and do not otherwise lie; and
  - (f) subject to paragraphs (a) to (e) (inclusive), this Act, the *Federal Court of Australia Act 1976* , the Rules of Court made under that Act, and other laws of the Commonwealth, apply in and in relation to the proceeding as if:

- (i) a reference to the Federal Court (other than in the expression "the Court or a Judge") included a reference to the Family Court;
  - (ii) a reference to a Judge of the Federal Court (other than in the expression "the Court or a Judge") included a reference to a Family Court Judge;
  - (iii) a reference to the expression "the Court or a Judge" when used in relation to the Federal Court included a reference to a Family Court Judge sitting in Chambers;
  - (iv) a reference to a Registrar included a reference to a Registrar of the Family Court; and
  - (v) any other necessary changes were made.
- (4) Where any difficulty arises in the application of paragraphs (3)(c), (d) and (f) in or in relation to a particular proceeding, the Family Court may, on the application of a party to the proceeding or of its own motion, give such directions, and make such orders, as it considers appropriate to resolve the difficulty.
- (5) An appeal does not lie from a decision of the Federal Court or the Federal Magistrates Court in relation to the transfer of a proceeding under this Act to the Family Court.

The claw back provisions, such as s 120 and 121 and a *Cummins* type argument (eg. *Pascoe and Nguyen* [2007] FMCA 194) are available.

A trustee in bankruptcy may decide not to intervene in s 79 *FLA* proceedings. There can be many reasons for this including:

- no assets have vested in the trustee from which legal costs can be paid
- no creditor is prepared to fund the trustee's legal costs
- if the bankrupt is not co-operative, the trustee may have very little evidence to contradict the evidence presented by or on behalf of the non-bankrupt spouse
- the asset pool is relatively modest and the trustee assesses the risks are too great that it will not retain sufficient assets to make a distribution to creditors. This decision is more likely if the non-bankrupt spouse has strong s 75(2) *FLA* factors in their favour
- exempt assets such as superannuation, household furniture, cars and tools of trade up to certain limits are a significant part of the pool

In *West & West* [2007] FMCA fam 681 the trustee had difficulty obtaining co-operation from the bankrupt and did not recover its costs. The wife offered to pay the primary debt of about \$8,000 but not the costs. The costs were about \$60,000 and O'Sullivan FM found they were disproportionate to the

debt and the property pool. The costs included in this calculation though, were both the petitioning creditor's costs to bankrupt the husband and the trustee's costs.

The Federal Magistrate found that including the costs as part of the debt reduced the net pool by almost 25%. He was not referred to any authority that required the interests of the trustee to be taken into account, but only the interests of the creditors. He did not distinguish between the petitioning creditor's costs and those incurred of the trustee. He ignored the order that the bankrupt pay the petitioning creditor's costs of the bankruptcy proceedings. The Federal Magistrate did not consider the trustee in bankruptcy to be a "creditor" within s 75(2)(ha) *FLA* .

FM O'Sullivan adopted the list (created by Federal Magistrate Walters in his paper "Some Aspects of the Interaction of Bankruptcy with Family Law," 12th National Family Law Conference, Perth 2006) of principles, considerations or factors likely to be relevant to the balancing exercise between the interests of the parties to the marriage and those of the creditors of a bankrupt spouse. Those factors are set out later in this paper.

Without the husband giving evidence there was no evidence of any contributions by him to the purchase of the former matrimonial home. The court was satisfied that the wife had made the majority of the contributions to the party's assets and that the assets (including superannuation) ought be divided 85% in favour of the wife. In relation to s 75(2) *FLA* factors the trustee was also hampered by the absence of evidence on behalf of the husband.

The Federal Magistrate considered it relevant under s 75(2)(ha) *FLA* that creditors were unlikely to receive a dividend from any monies which the court ordered the trustees be entitled to receive out of the matrimonial property. He agreed with the submissions on behalf of the wife and said (at para 111):

It would be *perverse* if the wife and children were "*forced from their home*" and the operation of those relevant provisions of that legislation in relation to "*the Trustees' costs*" meant RACV Finance would remain out of pocket.

In *Beeson and Spence* [2007] FamCA 200, the husband was declared bankrupt in April 2005 after judgment had been entered against him for \$64 million plus costs and interest. The trustee in bankruptcy chose not to intervene in the *FLA* proceedings. Her Honour, Justice Moore, made orders which meant the husband retained over \$1.4 million of superannuation, being 40% of the total pool.

Moore J considered the wife's entitlements to be 55%, but gave the wife the 60% offered to her by the husband.

If the trustee had been a party and successfully argued that the additional 5% property should have gone to the bankrupt, the trustee would have received some non-exempt property and there may have been funds to pay to the creditors. However, it was a risky case to run. The husband was only able to retain all his superannuation by succeeding in a s 106B *FLA* application to set aside a deed varying the terms of a discretionary trust. Possibly, the trustee and the creditors weighed up the costs and risks of the proceedings and considered them too great for the creditors to fund the trustee's costs.

### **Unsecured debts**

The Family Court often gives unsecured creditors without judgment debts priority over the claims of non-bankrupt spouses. Their claims have not been put to proof in a court, yet the debts are often treated by the parties and the Court as if they have been.

In *Biltoft and Biltoft* (1995) FLC 92-614 the Full Court looked at the position of unsecured creditors saying (at p 82,124):

A general practice has developed over the years that, in relation to applications pursuant to the provisions of s 79, the Court ascertains the value of the property of the parties to a marriage by deducting from the value of their assets the value of their total liabilities. In the case of encumbered assets, the value thereof is ascertained by deducting the amount of the secured liability from the gross value of the asset. See, *Ascot Investments Pty Ltd v. Harper & Anor* (1981) 148 CLR 337 where Gibbs J. (as he then was) pointed out at p 355 that the Court "must take the property of a party to the marriage as it finds it. The Family Court cannot ignore the interests of third parties in the property, nor the existence of conditions or covenants that limit the rights of the party who owns it". Where the assets are not encumbered and moneys are owed by the parties or one of them to unsecured creditors, the Court ascertains the value of their property by deducting from the value of their assets the value of their total liabilities, including the unsecured liabilities. See *Prince and Prince; General Credits Australia Limited (Intervenor); A-G for the State of Queensland (Intervening); A-G for the Commonwealth of Australia (Intervening)* (1984) FLC 91-501.

The Full Court then said (at p 87,127):

Notwithstanding the general practice which has developed, the Court has indicated that it may properly determine not to take into account or to discount the value of an unsecured liability in certain circumstances. Such liabilities would include but are not limited to a liability which is vague or uncertain, if it is unlikely to be enforced or if it was unreasonably incurred.

The Full Court concluded in relation to the general rule (at p 82,128-9):

The rule is not absolute, is not prescribed by the statute and there are a number of well recognised exceptions.... There is no requirement that the rights of an unsecured creditor or a claim by a third party must be considered and dealt with prior to the Court making an order under s 79, nor is there a rule of priority as between a creditor claimant and a spouse. Those rights, however, cannot be ignored. They must be recognised, taken into account and balanced against the rights of the spouse.... There is an obligation on both parties to disclose any significant creditors or any significant claim against either of them by a third party. If, as a result of the order of the Court in the property proceedings, the ability of a creditor or claimant to recover his or her debt or claim is likely to be affected, notice of the Family Court proceedings must be given to that creditor or claimant. He/she may then intervene in the Family Court proceedings and either seek a stay of those proceedings or some appropriate order which recognises his/her rights.

In the past, the Family Court was particularly concerned to ensure that revenue authorities such as the Australian Taxation Office and State Revenue Offices were paid (eg. *Chemaisse and Chemaisse* (1988) FLC 91-915). Priority was often been given to tax debts over the non-bankrupt spouse and other unsecured creditors (*Hannah and Hannah; Tozer and Tozer* (1989) FLC 92-052). However, Coleman J in *Lemnos and Lemnos* (2009) FLC 93-394 considered that the Australian Taxation Office no longer had priority over other creditors due to the *Insolvency (Tax Priorities) Legislation Amendment Act 1993*. Among other amendments, s 123(5) was deleted. This section protected payments of tax.

Also in *Lemnos*, the trial Judge, Le Poer Trench J, for different reasons, agreed. He said (cited at para 127 of the Full Court's judgment):

I have some concern with the outcome of this case insofar as the creditor principally to lose out in this case is the Australian Tax Office and therefore the tax payers of this land. The question should realistically be asked why the wife should ultimately prosper at the expense of the public purse. The answer so far as I am concerned is that the *Family Law Act* as now standing provides for that to be the outcome in appropriate cases. The legislation does not elevate the status of creditors to a ranking above the other considerations.

An unsecured liability may also be considered in the context of waste which is discussed later in this paper.

This section protected payments of tax.

## Contributions

Under the *FLA*, "waste" can be a "negative" contribution. In *Kowaliw and Kowaliw* (1981) FLC 91-092, Baker J said (at p 76,644):

As a statement of general principle, I am firmly of the view that financial losses incurred by parties or either of them in the course of a marriage whether such losses result from a joint or several liability, should be shared by them (although not necessarily equally) except in the following circumstances:

- (a) where one of the parties has embarked upon a course of conduct designed to reduce or minimise the effective value or worth of matrimonial assets, or
- (b) where one of the parties has acted recklessly, negligently or wantonly with matrimonial assets, the overall effect of which has reduced or minimised their value.

The Court has rarely been required to determine if bankruptcy is a negative contribution in itself. In *J and J* [2002] FMCA fam 269 both parties had been bankrupted. Their prior contributions were said by Roberts FM to have been "eroded" by their bankruptcies. The Family Court is not bound by this decision and the effect of bankruptcy on the assessment of contributions is still open.

### Section 75(2)(ha) *FLA*

The factors to be considered in property and spousal maintenance cases under s 75(2) *FLA* were changed by the 2005 Act. Section 75(2)(ha) *FLA* was added, requiring the Court to consider "the effect of any proposed order on the ability of a creditor of a party to recover the creditor's debt, so far as that effect is relevant."

In practice, this means that in the four-step process under s 79 *FLA*, after considering the contributions made by each of the parties to the marriage, the interests of creditors are one factor amongst many to be considered under s 75(2). The interests of creditors are not given more or less weight than other factors.

In *Lasic and Lasic* [2007] FamCA 1188 the husband's trustee in bankruptcy sought to set aside consent orders made between the husband and the wife, under which the husband's interest in 6 jointly owned pieces of real estate were transferred to the wife. At trial, the wife conceded that the inference was open that the consent orders had been entered into to avoid the payment of a possible damages award against the husband, such that the making of the orders was a miscarriage of justice. The trial Judge

relied on the wife's concession and "amended" the consent orders to require the wife to pay \$319,081 to Mr M, a creditor, who had sustained serious injuries as a result of being shot due to the negligence of the husband and the parties' son.

On appeal, in *Trustee for the bankrupt estate of Lasic and Lasic* (2009) FLC 93-402, Boland, Thackray and Ryan JJ said they understood the trial Judge's concern that if the husband's entitlement under the consent orders was paid to the trustee, Mr M would get nothing. Reluctantly, the Full Court concluded that the order for a direct payment by the wife to Mr M was not within the trial Judge's power.

In *Orchard and Orchard* [2008] FamCA 979, Dessau J acceded to the submissions under s 75(2)(ha) *FLA* of the husband's trustee in bankruptcy that she should consider it relevant that the husband's superannuation was exempt under s 116(2)(d)(iii) *BA*. The trustee wanted the wife to receive a super split and Dessau J ordered one. She said (at paras 93-4):

The effect of the order is that the wife shall not receive further assets immediately. She has received some, but I am conscious that the balance of her share of the settlement will be in superannuation that she cannot yet access (she is 48 years old). However, she is housed and financially secure with Mr W. She moves into the future secure, and this gives her own financial resource.

The effect of the order is the opportunity for the husband's creditors to be satisfied, as he shall retain the non-exempt asset.

In *Malta and Malta (No 3)* [2008] FamCA 748 Cronin J refused to take superannuation into account only as a s 75(2) *FLA* factor as the parties submitted. The husband sought an adjustment of 5% of non-superannuation in the wife's favour for his \$48,000 of superannuation, which meant the wife would only receive an extra \$17,000 of non-superannuation.

The wife's petitioning creditor was a party to the proceedings as the bankruptcy petition had been transferred to the Family Court. The wife was not yet bankrupt. Cronin J discussed s 75(2)(ha) *FLA* and refused to make an adjustment under s 75(2), saying (at paras 112 and 117):

I have contemplated the problem set out in s 75(2)(ha) relating to the orders I make in relation to creditors. In relation to the wife, it would clearly seem that there is nowhere near enough in the entitlement of the wife to enable her to satisfy all of her creditors. On the other hand, I have been told that the husband has a debt to the Australian Taxation Office of something in the vicinity of \$2 million and there is no prospect that he will be able to pay that. Whether anybody bothers to enforce that debt is a matter beyond my control...

One of the difficult issues in this case having regard to the bankruptcy jurisdiction that I am being asked to exercise is the fact that any order I make in favour of the wife may very well end up in the hands of a very few people particularly having regard to the costs of the petitioning creditor. As such, to make an adjustment of a modest sum in favour of the wife in this case would have little, if any, value for the wife. Her sum on all of the evidence I have seen, will end up in the hands of the creditors. Even so, there is little between the parties of difference when I balance up all of those factors. In my view, there is no basis for an adjustment under s 75(2) of the Act in this case.

In *Pippos and Pippos* [2008] FamCA 542, debts incurred by the husband post separation led to the husband's bankruptcy. Burr J gave the wife 5% on account of s 75(2) *FLA* factors. He said he would have given her 10% but the factors in her favour were partially balanced by those which favoured the trustee in bankruptcy under s 75(2) (ha) and (n) *FLA* and the regard he must have to the husband's creditors' ability to recover their debts. He did not seem to consider it relevant that the debts were incurred post-separation.

### **The Fourth Step**

The fourth step in the property settlement process is to assess the justice and equity of orders under s 79 *FLA* (eg. *Hickey and Hickey and the Attorney-General for the Commonwealth of Australia (Intervener)* (2003) FLC 93-143).

Burr J found in *Pippos and Pippos* (at para 62):

Whilst it is necessary in the journey towards a result in property settlement proceedings between the wife and the trustee to consider relevant matters which emerged from the marriage relationship, the rights of the husband's creditors and considerations which must apply to the husband's creditors represented by the trustee mean that ultimately the orders I make on the issue of property settlement are as between the wife and the trustee and hence it is to them that the justice and equity of my orders must apply.

The husband retained his superannuation benefits of \$17,000 which could not be accessed by the trustee as part of his 30% of the pool. The balance due by the wife to the trustee under the orders was \$39,741. That was \$20,000 more than the wife indicated that she had the capacity to borrow. Burr J was satisfied that it represented a just and equitable outcome in the circumstances. The orders recognised the wife's significant contributions during the marriage, the s 75(2) factors which favoured her position overall and the entitlement of creditors to recover a proportion of their debts. After deduction of the trustee's costs of \$31,500, the creditors were likely to recover \$8,241 of the total due to them of \$28,577, or a return of about 29 cents in the dollar.

## Setting aside orders and transactions under the *FLA*

In the past, a trustee could, in certain circumstances, challenge orders under s 79A *FLA* if the orders defeated their interests. A trustee usually argued that there had been a miscarriage of justice by reason of fraud, duress, suppression of evidence (including the failure to disclose relevant information), the giving of false evidence or any other circumstance (s 79A(1)(a) *FLA*).

The ability of creditors and the trustee to use s 79A *FLA* was considered in such cases as *Semmens v Commonwealth of Australia & Collector of Customs* (1990) FLC 92-116 and the *Official Trustee in Bankruptcy v Donovan* (1996) FLC 92-703. A creditor's standing to apply to set orders aside under s 79A was further clarified by the 2005 Act. Section 79A(4) provides that a creditor of a party is taken to be a person whose interests are affected by the order if the creditor may not be able to recover their debts because the orders was made

The trustee's standing to apply under s 79A *FLA* was made absolutely clear by (amending) (s 79A(5) *FLA*). A trustee is taken to be a person whose interests are affected by a s 79 *FLA* order if, when the order was made, one of the parties to the marriage was a bankrupt or a party became bankrupt after the order was made

A transaction made to defeat a claim is able to be set aside on more grounds than before 2005. If the trustee is a party to proceedings under the *FLA*, the Court may set aside or restrain the making of an instrument or disposition:

- which is made or proposed to be made by or on behalf of, or by direction or in the interests of, the bankrupt; and
- which is made or proposed to be made to defeat an existing or anticipated order in those proceedings or which, irrespective of intention, is likely to defeat any such order (s 106B(1A) *FLA*).

Section 106B(1) *FLA* can also be used by a trustee in bankruptcy.

An injunction can be granted on the application of the non-bankrupt spouse, restraining the trustee in bankruptcy from declaring and distributing dividends among the bankrupt's creditors (s 114(4) *FLA*).

## Financial Agreements

There is an argument that financial agreements are not as secure as consent orders if bankruptcy is a possibility. Consent orders have the approval of the Court and, provided there has been full disclosure of the debts and notice to third party creditors, they may be more difficult to set aside than a financial agreement entered into by the parties in private.

Following *ASIC v Rich* (2003) FLC 93-171, amendments were made to the *FLA* and the *BA* to protect the position of the trustee in bankruptcy and creditors with respect to a financial agreement. These amendments included:

- creditors have standing to apply to set a financial agreement aside (s 90K (1A))
- it is an act of bankruptcy if a person becomes insolvent as a result of a transfer or transfers made under a financial agreement (ss 40(1)(o) and 40(7) *BA* )
- the claw back provisions in the *BA* can be used to recover property transferred under a financial agreement (ss 40(1)(o) and 120 *BA*)
- a separation declaration must be made before a financial agreement comes into force or takes effect if it relates to property or financial resources of the parties ( s 90DA(1) *FLA*)

Transfers pursuant to court orders are protected by s 59A *BA*. Property transfers pursuant to a financial agreement can be clawed back under s 120(1) *BA* if the transfer took place within the previous 5 years and the transferee gave less than market value for the property transferred.

Interestingly, despite the 2005 Act which aimed to have all disputes between trustees in bankruptcy and non-bankrupt spouses heard in the Family Court, in *Combis, Trustee of the property of Peter Jensen (bankrupt) v Jensen* [2009] FCA 778, the Federal Court considered it had standing and held that it had jurisdiction to determine a claim with respect to a transfer of property pursuant to a financial agreement under s 120 and 121 *BA*. The court held that it was not necessary for a trustee in bankruptcy to apply under s 90K *FLA* in the Family Court to set aside the financial agreement.

## **Annulment of bankruptcy**

The possibility of an annulment is often highly relevant in disputes under the *FLA*. The bankrupt may have practical or extremely grand plans to pay out all creditors and the trustee's costs, and obtain an annulment. These negotiations can be very frustrating for the non-bankrupt spouse, especially if they are ultimately unsuccessful. The trustee has a statutory obligation to its creditors to try to obtain a payment to them in full so will give time to the bankrupt to try to annul the bankruptcy if asked to do so. Examples include *Freer and Freer* [2008] FamCA 131 and *Petresca and Petresca (No 2)* [2008] FamCA 1238.

### ***Lemnos***

The effect of the 2005 Act was considered recently by the Full Court in *Trustee of the Property of G Lemnos & Lemnos* (2009) FLC 93-394.

The trustee of the husband's bankrupt estate appealed against property orders which required that the former matrimonial home, which had vested in the trustee, be sold and the net proceeds divided equally between the trustee and the wife. The appeal was unpheld.

The trial Judge found that the wife had contributed directly to the matrimonial home through her income (from distributions received by her from the family trust which received income from the husband's legal practice) and the guarantee. Contributions were assessed as equal at the date of the trial.

The husband was re-assessed for income tax during the period 1991- 2002. A sequestration order was made against him in 2006, he was allowed to continue working as a solicitor and the parties separated in July 2007. At the time of the trial the equity in the home was approximately \$2-2.5 million and the husband's bankrupt estate had debts of about \$6 million.

The Full Court held that the interests of unsecured creditors did not automatically prevail over the interests of the non-bankrupt spouse and the Court must balance their competing claims in the exercise of the wide discretion conferred by s 79.

The wife argued that the husband wasted assets by acting recklessly and negligently in completing his tax returns, an act wholly within his knowledge. For twelve years he claimed outgoings on a property,

which was, for most of that time, his primary residence. The majority found that the husband's conduct was not within the exceptions to the *Kowaliv* principle, as it was not designed to *diminish* the value of the matrimonial assets, but to *increase* them. The wife received the benefit of the funds which flowed from the husband's conduct, and it was neither just nor equitable for her to escape all responsibility for payment of the *primary* tax.

The majority followed the Full Court in *Johnson and Johnson* [1999] FamCA 369 which said "unless there were compelling circumstances to the contrary, a just outcome demanded that the wife take the good with the bad" and that unless "the husband was on a frolic of his own and acting contrary to the wife's express wishes" there was no reason for the trial Judge to leave the husband with the burden of the tax penalties.

The majority in *Lemnos*, unlike in *Johnson*, accepted that the husband was "on a frolic of his own" but did not accept that the wife's lack of knowledge or complicity in the husband's wrongful deductions determined whether she should share responsibility for the payment of *primary* taxation on his income during the marriage. The statement in *Johnson*, that spouses should generally "take the good with the bad," had even more force when applied to allocating responsibility for *primary* taxation, rather than tax penalties.

Coleman J observed that, having ordered that the wife should receive 50% of the equity in the home, the trial Judge gave priority to the wife over the unsecured creditors. The unsecured creditors, owed approximately \$6 million, received the same dollar amount as the wife, or about 17.5-21.6% of their claims. Coleman J concluded that the trial Judge's discretion miscarried. By finding that the husband should satisfy the ATO debt from his resources, he had already decided the issue which s 75(2)(ha) directed him to consider.

In *Lemnos*, the Full Court in two separate judgments took a more favourable approach to the position of the trustee in bankruptcy than taken by the trial Judge. Thackray and Ryan JJ allowed the appeal because of the trial Judge's treatment of the primary tax burden as "waste." Coleman J allowed the appeal because of the way the trial Judge applied s 75(2)(ha). The parties were ordered to file submissions as to whether the Full Court should decide the matter or remit it for re-trial.

***Rand***

In *Rand and Rand (No 2)* [2009] FamCAFC 155 the husband appealed against an order entitling her to half of the profits arising out of patents or intellectual property relating to the conversion of waste material to building products and that the husband account to the wife and pay to the wife half of any profits received in respect of intellectual property of various companies and related entities. This entitlement to profits was limited to the extent of her unsatisfied property entitlements, costs and interest.

The majority considered the husband's standing to appeal. The trial, involving the husband, the wife, the husband's trustee in bankruptcy and eleven other third party respondents took place over 24 days between September 2007 and November 2007. By the time judgment was delivered, the husband was a discharged bankrupt.

The Full Court distinguished *Cummings v Claremont Petroleum NL and Anor; Fuller v Claremont Petroleum NL and Anor* (1995 - 1996) 185 CLR 124, *Giurgis v Giurgis Official Trustee in Bankruptcy* (1997) FLC 92-726 and *O'Neill v O'Neill* (1998) FLC 92-811. In relation to *Cummings*, the majority said (at para 41):

The bankrupts personally stood neither to gain nor lose by being permitted to appeal. Their trustees had not appealed the decision on their behalf. On the facts of the case, it would have been surprising, and potentially an abuse of the court's process to grant the bankrupts standing to appeal.

The husband in *Rand* had an "interest" which the bankrupt spouses in the other cases lacked.

The majority, Coleman & Crisford JJ distinguished *O'Neill* and said (at paras 49, 51):

The pivotal issue in the current appeal did not arise in any of the authorities to which we have referred. There was no issue in any of those cases that the fruits of a successful appeal would be received by the bankrupt's trustee or, to the extent that there might be a surplus, by the bankrupt to the extent of such surplus. The sole issue for determination in the present appeal is whether the order under challenge imposes obligations upon the husband personally or upon property vested in his former trustee in bankruptcy. The potential "interest" of the bankrupt is thus significantly dissimilar to that revealed in each of the authorities to which we have referred.

We are not persuaded that the husband lacks standing to prosecute his appeal. The outcome of this appeal may have significant implications for the husband in his pending appeal against orders made against him as a consequence of findings that he breached the order which gives

rise to the present appeal. In those circumstances, we are persuaded that the husband has an “interest” sufficient to provide standing to challenge the trial Judge’s order.

The majority concluded (at para 112):

Although a less than satisfactory state of affairs, the effect of the matters to which we have referred is that it falls to the husband’s former trustee in bankruptcy, by disclaiming or continuing not to disclaim the technology, to effectively determine the extent to which orders apparently directed to the husband personally actually impose personal obligations upon him. Regrettably, in the absence of any appearance by or on behalf of the husband’s former trustee in bankruptcy in this Court, we cannot take that matter further. However, nothing to which we have been referred, or discovered for ourselves, persuades us that the trial Judge’s orders would defeat attempts by the wife to enforce them against the husband’s former trustee in bankruptcy if he does not disclaim the technology, or against the husband if he does. How successful any such attempts may prove is another question altogether, and not one requiring determination in this appeal.

Warnick J dismissed the appeal for different reasons.

### **What approach to take to debts?**

Federal Magistrate Walters, in the 2006 paper referred to above, set out a list of “*principles, considerations or factors*” likely to be relevant to the “*balancing exercise*” that is the property settlement process where the interests of the parties to the marriage and those of the creditors of a bankrupt spouse are involved. He suggested that, where applicable, they should form the subject of appropriate evidence:

- "(a) Any order that the Court might be minded to make which is likely to impact upon a creditor in the sense of affecting the creditor's rights must be "reasonably necessary, or reasonably appropriate and adapted ..." to effect a just and equitable division of property between the parties to the marriage and must take into account the legitimate interests of that creditor (see *FLA s 90AE(3) and(4)*);
- (b) The Court might be minded to consider, including in the context of (for example) an "add back", or in the context of deciding whether or not to "ignore" a debt:
  - (i) whether one of the parties "... has embarked upon a course of conduct designed to reduce or minimise the effective value or worth of matrimonial assets", or whether a party "... has acted recklessly, negligently or wantonly with matrimonial assets, the overall effect of which has reduced or minimised their value". (see *Kowaliw*);
  - (ii) The non-bankrupt spouse's knowledge of the events leading to the other spouse's bankruptcy, including (for example) the nature and degree of the non-bankrupt spouse’s involvement in the business or investment activities of the bankrupt

spouse, and whether, and to what extent, the non-bankrupt spouse "... has either benefited from, or contributed to, the bankrupt spouse's insolvency"; (CCH *Australian Family Law & Practice*, para 40-740)

- (iii) When and how a relevant debt was incurred by the bankrupt spouse, and whether, for example, the debt was incurred "in deliberate or reckless disregard of (the non-bankrupt spouse's) potential entitlement under s 79". *Biltoft, Kowaliw and Asic v Rich*)
- (iv) The factual circumstances surrounding the commencement or continuation of the property settlement proceedings – including, for example:
  - whether the parties' marriage has broken down and/or the parties have separated; and/or ;
  - whether property settlement proceedings are or appear to be a strategic or tactical plan or initiative designed, in some way, to insulate the assets of the family (or a member of the family) from creditors, or to otherwise prevent creditors (or the Trustee on their behalf) from recovering their debts, or an appropriate part thereof.
- (v) Whether a creditor knew or ought to have known of a claim or potential claim by the non-bankrupt spouse to the bankrupt spouse's property prior to or at the time that the debt was incurred;
- (vi) Whether and in what manner the creditor pressed or pursued – directly or indirectly – his/her rights in relation to the payment of the debt prior to bankruptcy, or prior to the commencement of proceedings in the relevant Family Law Court, and whether the creditor did so in a timely fashion;
- (vii) Whether, by words or conduct, a creditor (or Trustee) led or permitted the non-bankrupt spouse to form a reasonable view that the debt would not be pressed, pursued or enforced, and whether (and in what way) the non-bankrupt spouse was thereby induced – whilst acting in good faith – to change his/her financial position;
- (viii) Whether, by words or conduct, the non-bankrupt spouse led or permitted the creditor (or Trustee) to form a reasonable view that the non-bankrupt spouse's actual or potential entitlements under the *FLA* would or might not be pressed, pursued or enforced, and whether (and in what way) the creditor (or Trustee) was thereby induced – whilst acting in good faith – to change his/her financial position.
- (ix) Whether either of the spouses has failed to make a full and frank disclosure of his/her financial position at all relevant time;
- (x) Whether the Trustee has failed to make a full and frank disclosure of all relevant information as it relates to the identification and valuation of the property

comprising the vested bankruptcy property, and a full and frank disclosure of all relevant information relating to provable debts;

- (xi) The overall financial circumstances of the non-bankrupt spouse and the children of the parties during the period since the incurring of the relevant debt or debts, and at the time of the property settlement proceedings (including the effect on the non-bankrupt spouse and the parties' children of the orders proposed by the parties to the proceedings)."

These seem to be a sensible starting point for the parties to address in the absence of more specific Full Court guidance. Other factors which might be relevant are:

- Whether the debts were incurred pre- or post-separation
- Whether the debts were incurred directly or indirectly for the benefit of both parties

### **Conclusion**

On the face of it, since the 2005 Act, the Family Law Courts are better able to take into account the interests of the trustee in bankruptcy in determining applications for a property settlement or spousal maintenance. It more frequently hears from any trustee in bankruptcy. Timing is less important. If *FLA* orders are made without proper notice to creditors or a trustee in bankruptcy, they can be set aside more easily than in the past.

The Court has the power to make orders such as:

- that property which vested in the trustee at the date of bankruptcy be transferred to the non-bankrupt spouse
- that a debt which is part of the bankruptcy be paid from property which has not vested in the trustee in bankruptcy
- that the non-bankrupt spouse receive some or all of their entitlements in superannuation so that there is more non-exempt property available for the trustee

The insertion of s 75(2)(ha) *FLA* means that in the 4-step process under s 79 *FLA*, after considering the contributions made by each of the parties to the marriage, the interests of creditors is one of the factors to be considered under s 75(2) *FLA*. In practice though, it appears to be given no more weight than the other factors and creditors may lose out against a non-bankrupt spouse with significant s 75(2) *FLA* factors such as being on a low income with young children.

At some stage the Full Court will need to reconsider *Kowaliw* and give clearer guidance as to which debts are "debts of the marriage" which should be paid from the property of the parties when calculating the net pool. FM Walters' paper provides helpful assistance in the meantime.

Parties to the marriage and trustees in bankruptcy need to remember that the *BA* still applies and that the trustee can use *BA* principles to protect and enlarge its interests either under s 35 or s 35A *BA* in the Family Court or by asking the Federal Magistrates Court to exercise its dual jurisdiction.

The *BA* claw-back provisions and *Cummins* offer trustees in bankruptcy more hope and opportunity than the 2005 Act does. It is likely that in cases with significant asset pools and significant debts (e.g. *Cummins* and *Lemnos*), trustees or creditors with deep pockets such as the Australian Taxation Office, will be willing to fund the proceedings and pursue claims under the *BA* rather than rely on the *FLA*.

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