

# WHAT'S MINE IS YOURS

Bankruptcy and family separation make a complex and competing property mix, but it seems the principle of a couple sharing good and bad times applies. **By Jacqueline Campbell and Coralee Elsum**

**T**he interaction of family law and bankruptcy law brings about a conflict between the rights of a trustee in bankruptcy and of the separated spouse of a bankrupt, each seeking to claim against the property of the bankrupt. The *Bankruptcy and Family Law Legislation Amendment Act 2005* (Cth) ("the 2005 Act") amended the *Family Law Act 1975* (Cth) and the *Bankruptcy Act 1966* (Cth) to resolve the conflict. After a number of judgments that arguably favoured the non-bankrupt spouse,<sup>1</sup> the effect of the 2005 Act was considered by the Full Court of the Family Court in *Trustee of the Property of G Lemnos & Lemnos and Anor* ("Lemnos").<sup>2</sup>

## The 2005 Act

Until 19 September 2005, the rights and entitlements of the bankruptcy trustee and creditors as against the non-bankrupt spouse were often resolved on the basis of which claim was first finalised by a court.<sup>3</sup> Some cases in which creditors sought priority over the non-debtor spouse were resolved on the basis of "the roller coaster principle", meaning that parties in a marriage partnership had to share in the bad times as well as the good times.<sup>4</sup>

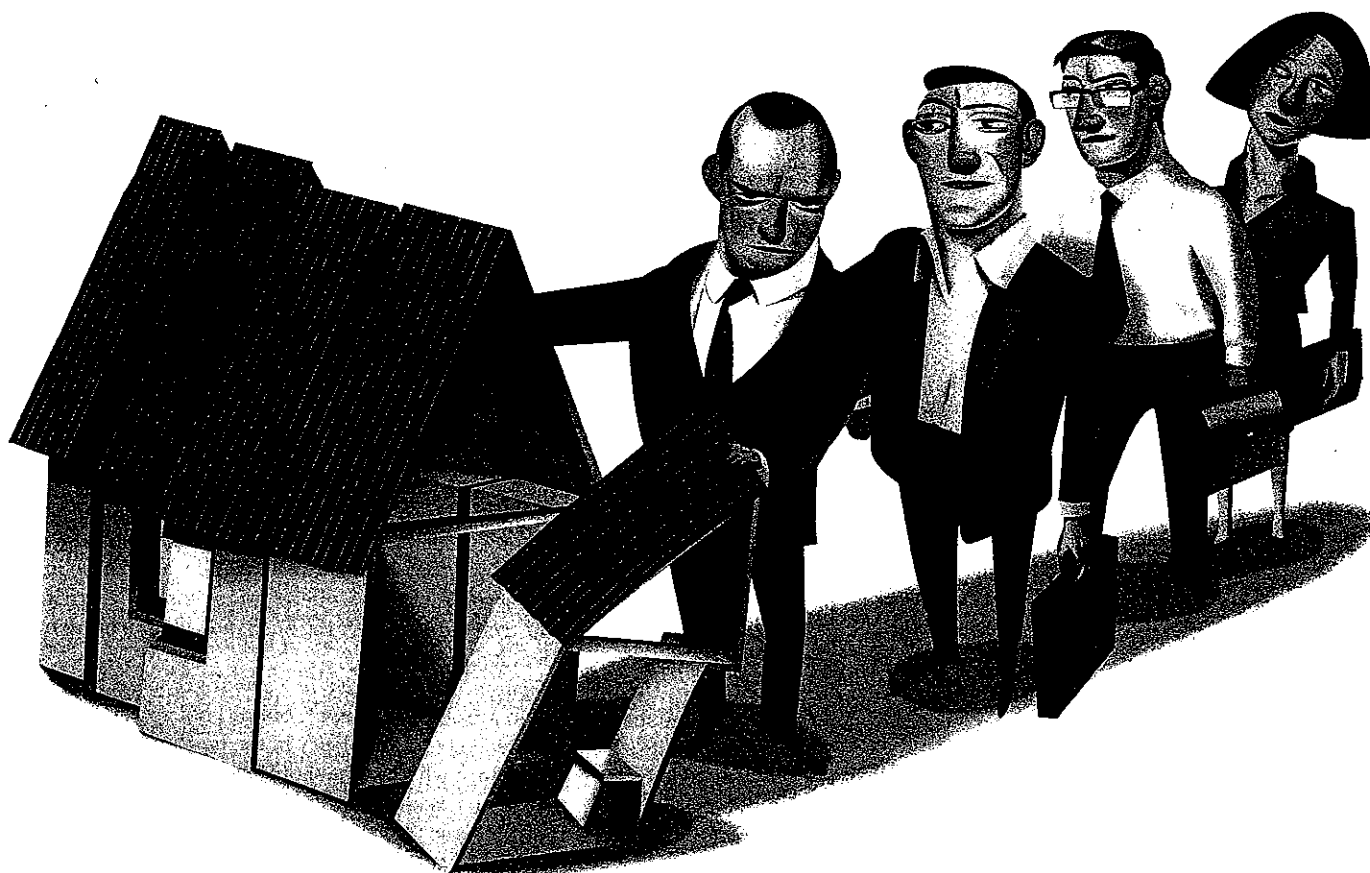
The 2005 Act allowed disputes between the trustee in bankruptcy and the non-bankrupt spouse about the property of a separated bankrupt spouse to be dealt with by one court, the Family Court.<sup>5</sup>

The Family Court has the power to make orders about property that has vested in a trustee in bankruptcy in property settlement proceedings related to that property. In determining applications for property settlement or spousal maintenance, s75(2)(ha) requires 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".

A trustee must be joined as a party to property settlement proceedings if:

- (a) the trustee applies to be joined; and
- (b) a party was bankrupt when the application was made or became bankrupt before the application is determined; and
- (c) the court is satisfied that the interests of the bankrupt's creditors may be affected by the making of a property settlement order (s79(11)).

The 2005 Act brought in a new era of uncertainty, as there was no clear direction as to how these disputes should be resolved. In *Lemnos*, the Full Court had the opportunity to consider the 2005 Act. Coleman J, outlining the problem, said that the intention of the 2005 Act was that the rights of unsecured creditors of a bankrupt spouse to a share of the bankrupt's estate were no longer automatically preferred to the property settlement rights of the non-bankrupt



spouse, but the “more vexing question” was how such rights were to be regarded (at [57]).

### Facts of *Lemnos*

The trustee of the husband’s bankrupt estate appealed against property orders requiring that the former matrimonial home, which had vested in the trustee and the wife. Thackray and Ryan JJ upheld the appeal, as disproportionate weight was given to the wife’s lack of complicity in the husband’s indiscretions and inadequate weight was given to the fact that the wife had benefited from those indiscretions. Coleman J also upheld the appeal, but for different reasons.

The parties were married for 31 years, were in their 50s and had four adult children. In 1989 the husband purchased the matrimonial home for \$1,300,000. The wife guaranteed the mortgage and a jointly-owned property was part security. The parties’ earnings were the husband’s income as a solicitor and the wife’s distributions from a family trust, which were primarily generated through the husband’s legal practice. The trial judge found that the wife had contributed directly to the matrimonial home through her income and the guarantee. Contributions were assessed as equal at the date of the trial.

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

### What approach to take?

The trial judge considered that the 2005 Act required him to take the usual approach under Part VIII of the *Family Law Act*, except that he had to treat all of the husband’s property, which had vested in the trustee, as available for distribution to the wife if appropriate.

The trustee focused on the “four step process”,<sup>6</sup> submitting that the case should have terminated at the end of the first step because there was no property available for property orders to be made against. Had the case been decided one day before the making of the sequestration order, and the four step process followed, the wife would have received nothing. It was “extraordinary” if the wife’s rights were greater because a sequestration order was made before final orders were made. The “usual balance sheet approach” revealed a substantial excess of liabilities over assets, leaving no “property” of the parties.

**The wife received the benefit of the funds that 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 trustee's approach significantly enhanced the position of an unsecured creditor. Rather than having to "take its chances" on being paid, the unsecured creditor would be paid after the entitlements to secured creditors were satisfied, and without regard to the rights of the non-bankrupt spouse. The "fortuitous breakdown of the marriage of the debtor" would result in the unsecured creditor potentially being able to recover more than if the debtor remained married (at [98]). The Full Court did not agree with this approach.

The trustee argued that the trial judge should make a finding formulated as a money order in favour of the wife against the husband and that the wife should claim with the other creditors in the bankruptcy. Applying the "*pari passu* principle", the wife would receive the same proportion of her debt as other creditors, satisfying s75(2)(ha) and giving a just and equitable result as mandated by s79(2). Thackray and Ryan JJ noted that applying s75(2)(ha) might reduce the non-bankrupt spouse's entitlements and there would not be "equal treatment" as the unsecured creditor's entitlement would remain at full value. They said that if Parliament had intended the non-bankrupt spouse's entitlement to be treated as if it were a debt provable in the bankruptcy, it would have amended the *Bankruptcy Act*.

All members of 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 s79.

#### Waste argument

The wife relied on s75(2)(o) and said the husband wasted assets as described in *Kowaliv and Kowaliv*<sup>7</sup> by acting recklessly and negligently in completing his tax returns – an act wholly within his knowledge. For 12 years he claimed outgoings on a property which was for most of that time his primary residence.

The husband conceded that he knew and understood s51 of the *Income Tax Assessment Act 1936*, made mistakes in his tax returns, wrongly claimed sums, and had been reckless in failing to ensure that his returns contained his correct residential address. The trial judge found that the wife was not complicit in the filing of the husband's returns.

The trial judge concluded that the husband should satisfy his tax debt from his own resources and observed that there was likely to be a "very substantial deficit". Thackray and Ryan JJ were surprised

that they were not informed of the husband's income for the relevant period. The evidence was only as to 1990–91, when the parties' combined income was sufficient to service a substantial mortgage. Without detailed information about gross incomes and mortgage interest, the majority found it was impossible to determine whether the husband could have acquired, renovated and retained the home without taxation relief.

The majority also found that there was insufficient evidence to determine that the husband should be solely responsible not only for the interest, penalties and costs incurred due to his behaviour, but also for the primary tax payable. They were unable to find that the husband's conduct was 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 that 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*,<sup>8</sup> which said that "unless there were compelling circumstances to the contrary, a just outcome demanded that the wife take the good with the bad" (at [20.6]), 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 (at [20.7]).

Unlike in *Johnson*, the majority in *Lemnos* 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.

#### Section 75(2)

Relevant matters in *Lemnos* under s75(2) included the wife's limited earning capacity, due to her lack of experience and skills and health issues, while the husband was a very experienced property lawyer although he had little incentive to earn a large income during his bankruptcy. The wife contributed substantially to the husband's success by caring for the family. The trial judge concluded that he needed

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to balance these matters against the very substantial loss that the creditors in the husband's bankrupt estate would suffer.

The trustee argued that there should be an adjustment of 100 per cent or thereabouts in its favour, but the creditors would still have a very substantial loss. The trial judge found that the balance fell in favour of the trustee regarding adjustments under s75(2). Given the size of the debt, it was inappropriate to make any further adjustment in favour of the wife, except in relation to a motor vehicle driven by her.

Coleman J considered that the Australian Taxation Office (ATO) no longer had priority over other creditors due to the *Insolvency (Tax Priorities) Legislation Amendment Act 1993* (Cth). In earlier cases, such as *Hannah and Hannah; Tozer and Tozer*,<sup>9</sup> priority was given to tax debts.

Coleman J observed that, in ordering that the wife should receive 50 per cent 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 per cent of their claims. Coleman J concluded that the trial judge's discretion miscarried. The trial judge had determined, before considering s75(2)(ha), that the husband should satisfy the ATO debt from his resources. This approach was erroneous as the trial judge had already decided the issue which s75(2)(ha) directed him to consider.

Coleman J perceived that the trial judge might have given disproportionate weight to the "innocence" of the wife in relation to the husband's taxation indiscretions and failed to have regard to the nature of the husband's indebtedness, how it arose, and how the wife must have benefited.

Thackray and Ryan JJ agreed that the trial judge appeared to decide the issue that s75(2)(ha) required him to consider before he considered that section. He had found that an adjustment in favour of the trustee was not warranted because it would work an injustice and hardship upon the wife. The implication was that the trial judge would have made an adjustment in favour of the trustee under s75(2), notwithstanding his earlier statement that the husband should meet the entire tax liability.

Furthermore, as the trial judge's orders would lead to the unsecured creditors receiving only a very small proportion of their entitlement, he ought to have explained, at least briefly, in what way any adjustment in favour of the trustee would cause the wife "injustice and hardship".

The appeal was allowed and the parties were ordered to file and serve submissions as to whether or not the Full Court should decide the matter or remit it for retrial.

### Conclusion

In *Lemnos*, the Full Court in two separate judgments took a more favourable approach to the position of the trustee in bankruptcy than that 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 s75(2)(ha).

Major points arising from *Lemnos* are that the position of creditors must be considered under s75(2)(ha) at the third step, and not merely when determining contributions at the second step. Furthermore, if the non-bankrupt spouse has significantly benefited from the actions of the bankrupt, albeit that the bankrupt was solely responsible for conduct which brought about the bankruptcy, the non-bankrupt spouse may have to bear some responsibility for debts from which they have benefited. The extent to which the Full Court was swayed by the identity of the main debtor being the ATO is uncertain. It is clear, though, that the roller-coaster principle is back. ●

JACQUELINE CAMPBELL is a partner with Forte Family Lawyers, an accredited specialist in family law and a collaborative lawyer. CORALEE ELSUM is a lawyer with Forte Family Lawyers.

Note that numbers in square brackets in the text refer to paragraph numbers in the relevant judgment, unless otherwise indicated.

1. *The Trustees of the Property of John Daniel Cummins, A Bankrupt v Cummins* [2006] HCA 6, which was decided on the basis of the *Bankruptcy Act* before the 2005 amendments (but after they came into effect). In *West and West* [2007] FMCAfam 681, the wife offered to pay the primary debt of about \$10,000 but not the trustee's costs of about \$60,000, which the federal magistrate found were disproportionate to the debt and the property pool.
2. FN [2009] FamCAFC 20.
3. D Shiff and P Waters, "Bankruptcy and Family Law: First Come, First Served?" [1985] 8(1) *UNSWLawJ* 40.
4. "A Question of Priorities: Wives or Unsecured Creditors", Lindenmayer J (1992) 6 *Australian Journal of Family Law*, 240 at 246.
5. The Federal Magistrates Court retains its dual jurisdiction.
6. *Hickey and Hickey and the Attorney-General for the Commonwealth of Australia (Intervener)* (2003) FLC 93-143.
7. (1981) FLC 91-092.
8. [1999] FamCA 369.
9. (1989) FLC 92-052.

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