

Bankruptcy and Family Law

Life after the 2005 Amendments

Introduction

One of the purposes of family law is to ensure that there is a fair and equitable distribution of matrimonial property between the parties to a marriage. The primary purpose of bankruptcy law has always been to realise the bankrupt's property and distribute it for the benefit of unsecured creditors. Where the two intersect has always raised difficult questions of law, procedure and policy, which have in turn caused headaches (and probably heartaches) for litigants, judges, lawyers and trustees in bankruptcy.

The purpose of this paper is not to give a history lesson but to look at how the most recent legislative attempt to create harmony (ie the *Bankruptcy & Family Law Legislation Amendment Act 2005*) is being interpreted and applied. It has now been almost three and a half years since the amendments commenced and we are starting to see some judgments being handed down. With reference to some of those cases, I will endeavour to assess whether the objectives are being achieved.

The key amendments

There are a number of articles and commentary which set out the detail of the 2005 amendments. For the purpose of this paper the most important changes are:

1. The Family Court now has exclusive jurisdiction over matters in which there are both family law and bankruptcy issues. The amended s35 Bankruptcy Act ("BA") makes it clear that the Family Court exercises bankruptcy jurisdiction where the trustee is a party to property or spousal maintenance proceedings. The Family Court has always had some bankruptcy jurisdiction and in rare circumstances can make sequestration orders (see *Malta & Malta and Ors* (no 3) [2008] FamCA 748);
2. Changes to the definitions in s4 of the Family Law Act ("FLA") were also made:

- a. “matrimonial property” (which now includes property that is vested in the trustee in bankruptcy); and
 - b. “matrimonial cause” (which now includes litigation between a party to the marriage and a trustee in bankruptcy).
3. The trustee now “stands in the shoes” of the bankrupt spouse and there is a procedure pursuant to s79(11) FLA (for property claims) and 74(2) FLA (for maintenance claims) for the trustee to apply to be joined as a party to the proceedings;
4. This also means that without leave of the court the bankrupt spouse won't be able to appear in relation to arguments on vested property unless leave of the court is obtained and such leave will only be granted in exceptional circumstances (see ss79(12) & (13) FLA). There will still be a right to appear to be heard in relation to non-vested property (eg superannuation does not vest in the trustee). In *Reua & Reua* [2008] FamCA 1038, the husband was granted leave to appear and the exceptional circumstances were said to be that:
 - a. There was no opposition to the grant of leave;
 - b. He was a participant in the proceedings in any event as he was seeking orders in relation to non-vested property; and
 - c. He had knowledge of the circumstances in which the unsecured debts were incurred.

This appears to be a relatively low threshold for “exceptional” and is also interesting because there have been other cases where the bankrupt husband has not given evidence in the proceedings and the Court has expressed some frustration at only hearing one side of the story!

5. Perhaps most importantly, section 75(2)(ha) obliges the court to consider the interests of creditors in making any property related orders. Interestingly, the interests of creditors are only one of the factors that need to be considered. There is no priority or preference accorded to the interests of creditors. I will

return to this issue later.

Bankruptcy litigation

Before I go on to discuss the cases I have selected, I should point out that as a general proposition bankruptcy trustees are remunerated from the assets of the bankrupt that they realise for creditors. In the distribution of funds there is a statutory priority (s109 BA) for the trustee's fees. This means that in truly asset less bankruptcies the trustee will be out of pocket for the time spent (and disbursements incurred) in complying with the Bankruptcy Act. Sometimes trustees are funded by creditors or external sources, but more often than not they effectively conduct matters on a speculative basis.

The first decided case: *West & West* [2007] FMCAFAM 681

This is the first case that I could find which considered the new provisions. It was heard in April 2007 and judgment was given in September 2007.

The relevant facts are that after 30 years of marriage the husband became bankrupt when he failed to pay approximately \$8000 on a car loan (and the financier was effectively the only creditor). The total net asset pool was approximately \$146,000. By the time the matter got to trial the costs and expenses of the bankruptcy had risen to \$69,000 (this included the costs of the petitioning creditor, the trustee's legal fees and his remuneration and disbursements).

In a "pre-amendment world" the property would have been sold, the trustee's fees paid and the balance distributed to unsecured creditors. However, in exercise of its new found jurisdiction, the court proceeded to apply the "normal family law four step approach". O'Sullivan FM ordered that the wife repay the finance company (which she offered to do) and then proceeded to ignore the costs and expenses of the trustee. It was found that 75(2)(ha) referred to the interests of creditors NOT the fees of the trustee and also that it would not be just and equitable to remove the wife from the family home.

On one view this case is a fair result for everyone except the trustee and his lawyers who had no doubt put considerable effort into the litigation for no return. This type of decision will no doubt influence trustees in deciding whether or not to be joined to proceedings or whether they should pursue assets of the other spouse in cases where there are small asset pools.

The first Full Court case: *Lemnos & Lemnos*

The first instance decision can be found at [2007] FamCA 1058 and the Full Court decision at [2009] FamCAFC 20. This case involved a marriage of about 30 years. The husband who was a solicitor became bankrupt over a \$3M debt owed to the ATO. The net value of the assets vested in the trustee (primarily a property) was approximately \$2.5M.

The trial proceeded “in the usual manner adopted for the consideration of Part VIII property applications” and the court considered the nature of the assets, their value and the respective contributions of the parties to them.

The trial judge (Le Poer Trench J) found that the doctrine of waste applied and husband had been negligent and/or reckless in the preparation of his tax returns. The tax debt had arisen because over a period of about 10 years he had claimed deductions that he was not entitled to in respect of his principal place of residence. The wife was not complicit in his actions. Accordingly, an order was made that the property should be sold and the proceeds divided equally. This meant that the husband should meet the tax debt out of his own resources. His Honour did note that the “tax payers of this land” were disadvantaged by this order but there was nothing in the legislation which gave them a priority¹.

The submission on behalf of the trustee was that the court should determine the wife’s entitlement in dollar terms in accordance with established family law principles. She should be treated as a creditor of the bankrupt estate as an unsecured

¹ A similar result was also achieved in *Worsnop & Worsnop* (No 2) [2007] FamCA 1315 where the tax debt of \$12M completely dwarfed the \$4.75M value of the matrimonial home. Once again the wife was found to be innocent and the property was ordered to be sold and the proceeds divided.

creditor for that amount and share on a pari passu basis with other creditors. This was rejected.

The pari passu argument was again advanced on appeal but to no avail. Consequently it is now clear (if there ever was any doubt) that there will be no priority given to creditors and their interests are just one of the numerous factors that the court will consider. The trustee also (unsuccessfully) argued that there was no property (within the definition of s4 FLA) to be divided between the creditors and the wife as the value of the creditors claims exceeded the equity in the property.

However, he was successful on an argument that the trial judge had erred in the exercise of his discretion. Coleman J found that the trial judge had made the finding that the husband should bear the tax debt from his own resources before he considered the application of s79(2)(ha) FLA.

Thackray and Ryan JJ said that the trial judge's discretion had miscarried because the *Kowaliw* waste doctrine did not apply. While they accepted that the husband had been reckless and negligent in the preparation of his tax returns the effect of what he had done was to increase the asset pool and not to decrease it (ie the property was acquired, at least partly, with funds that should have been paid in tax).

The end result of this case is that the trustee's appeal was successful and the Full Court has decided that the discretion should be re-exercised. Submissions were invited as to whether this exercise should be performed by the Full Court, the original trial judge or a separate single judge. At the time of writing this paper I do not know the outcome of those submissions.

The issue of fees and asset pools

The trustee in *Pippos & Pippos* [2008] FamCA 542 fared better than his counterpart in *West*. In this case there was a net asset pool of \$189,000 (including non-vested superannuation of \$17,000) with the creditors of the bankrupt spouse totalling \$28,000 with trustee's costs and disbursements of \$31,500. The debts which led to the bankruptcy were post separation debts.

After going through the four step process the court divided the asset pool 70:30 in favour of the wife. The orders made required the wife to make a payment (after borrowing funds to do so) to the trustee in return for keeping the matrimonial house. This meant that after payment of the trustee's fees unsecured creditors would receive a dividend of 29 cents in the dollar. This is significantly less than they would have received had pure bankruptcy principles applied.

Another example of where trustee's fees became an issue was the case of *Lasic & Lasic* [2007] FamCA 837. This case is in a slightly different category to the ones discussed above because it was an application under s79A FLA to set aside consent orders. The issue of s79A jurisdiction was not contested by the wife.

In this case the husband became bankrupt in June 2000 in respect of a judgment for personal injury damages of approximately \$200,000 which was awarded by the NSW Court of Appeal reversing a judgment of the District Court. It appears that prior to judgment being given in the District Court (in 1998) the husband and the wife filed consent orders in the Family Court pursuant to which all property was transferred to the wife. The effect of the consent orders was to defeat the recovery of the judgment debt. The trustee commenced proceedings in 2005.

The judgment debtor was the only creditor of the bankrupt estate and by the time of the trial his judgment debt including interest and costs was approaching \$500,000. The net assets of the wife were approximately \$3.6M plus an additional \$1M in superannuation. The trustee's claim (including his costs and expenses) was \$0.9-\$1.8M.

The court made a number of adverse comments about the level of the trustee's fees and the efforts that were made to involve the husband directly in the proceedings. The husband was said to be suffering from dementia and in a nursing home (and he died subsequent to the hearing but before judgment). Once again the court made the observation that the trustee was not a creditor and accordingly his fees were not something that needed to be considered under s75(2)(ha).

The court ultimately ordered the wife to directly pay the judgment debtor (the only creditor) the sum of \$319,000. In a separate judgment (see *Lasic* (No 2) [2008] FamCA 80) the wife was ordered to pay the trustee's costs of the proceedings on an indemnity basis because of her (and her husband's) deceitful conduct. Clearly this is only a fraction of the total fees that the trustee had incurred in his administration of this estate.

This case is currently the subject of a reserved judgment from the Full Family Court.

What emerges from these cases?

1. The Family Court appears to be taking the conferral of exclusive jurisdiction in these mixed bankruptcy family law matters quite literally. The judges appear to have no problems about approaching matters on a business as usual basis and applying the four step process to these matters. This means that the non-bankrupt spouse receives their share and the trustee is left to deal with the share allocated to the bankrupt spouse. This is different to how bankruptcy would deal with property division. Trustees would be used to getting in the property, paying expenses and giving the non-bankrupt spouse their share;
2. The Family Court is clearly not impressed with claims for trustee's fees and expenses particularly where those claims are large in comparison to the claims of creditors or the size of the asset pool. It is also clear that 75(2)(ha) is being interpreted as requiring the interest of creditors and not the interest of the trustee in his own fees to be taken into consideration. While trustees will probably see these types of decisions as unfair, it is to be hoped that the risk of non-recovery of costs may drive a more commercial attitude to proceedings and may promote early negotiation or settlement;
3. The court does not appear to have any difficulty in making orders that payments go directly from the non-bankrupt spouse to creditors. This is of course, repugnant to trustees who have been used to controlling the distribution of assets. There does not seem to any direct prohibition on such orders being made;

4. The cases also highlight some procedural problems for trustees in these cases. In *Lasic*, *Lemnos* and *West*, the bankrupt husband did not participate in the proceedings, although in *Lemnos* the trustee made an application for the issue of an arrest warrant to bring him before the court on the second day of the trial. The court refused to issue a warrant and instead issued a subpoena and the husband attended. Bankrupts have a duty to co-operate with their trustees, but it is very difficult to get an unwilling witness to be involved in proceedings at the best of times. However, if trustees are not able to get proper evidence from the bankrupt then the court may simply accept the non-bankrupt's spouses evidence on various issues including the identification of assets, their value and the contribution made to them.

Two interesting issues?

Clearly, there are many other issues that will only be resolved as the body of case law builds up. However, there were two issues of particular interest that occurred to me in the preparation of this paper:

1. Firstly, there is the issue of whether a couple need to be separated as a precondition of the court's exercise of jurisdiction under s79 FLA. The answer appears to be "no", but some commentary says that non-separated spouses may be refused property orders on the basis that it would not be just and equitable to make orders. The significance of this issue is that in cases involving a bankruptcy, the non-bankrupt spouse will often be significantly better off in the Family Court (if for no reason other than the recognition of their non-monetary contributions to the marriage). How long will it be until a happily (apart from the bankruptcy) married non-bankrupt spouse tests the jurisdiction?; and
2. Secondly, some of the commentary prior to the introduction of the legislation expressed the view that trustees would only be able to use the new provisions as a shield (i.e. to resist claims by the non-bankrupt spouse) and not as a sword (i.e. to try and increase the property available in the bankruptcy). This is a very interesting issue, particularly when both the BA and FLA have

provisions aimed at preventing the dissipation of assets to defeat the purpose of the legislation and to claw back such assets. How long will it be before an adventurous trustee launches an offensive action or attempts to use the BA clawback provisions in the Family Court and what will happen when he does?

Conclusion

It is still only relatively early days in the new bankruptcy and family law regime. There has only been one Full Court decision and another is reserved. Certainly in relation to property matters it appears that the usual family court methodology will apply and the court will exercise a very broad discretion. It appears that particularly where there are small asset pools non-bankrupt spouses will be better off. Trustees will no longer necessarily be safe in the knowledge that their costs and expenses will be treated as a first priority and the returns to creditors (including the ATO) will be diluted. It seems that in the competition for assets between spouses and unsecured creditors family law considerations currently have the upper hand. It remains to be seen how the many other unresolved issues pan out.

Paul Cutler

March 2009