



The clash of the new millennium: Bankruptcy v family law

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CCH Feature Article

Nabil Wahhab, Associate with The Argyle Partnership Lawyers, Sydney foresees a David and Goliath battle between trustees and spouses, and some tough decisions for the Family Court under the proposed family law and bankruptcy regime.

On 11 August 2004, Attorney-General Philip Ruddock introduced the *Bankruptcy and Family Law Legislation Amendment Bill 2004* (the Bill) to Federal Parliament. According to Mr Ruddock, the Bill demonstrates "the Government's continuing commitment to reform family law and bankruptcy law". There have been long-standing concerns about the uncertainty facing both bankruptcy trustees and non-bankrupt spouses when these two areas of law operate concurrently. Is the Bill an overreaction by the Government or a measured response to the clash between bankruptcy and family law?

The Bill implements recommendations from the *Joint Task Force Report on The Use By High Income Professionals of Bankruptcy and Family Law Schemes to Avoid Payment of Tax*. The Bill's genesis are founded in two recent decisions, one involving a bankrupt barrister in the Federal Court and the other a non-bankrupt not-separated company director of the failed One.Tel company in the Family Court.

Over the years there have been a number of cases where parties litigating in the Family Court found themselves concurrently litigating in other courts in relation to bankruptcy. The cost for parties in those cases would have been very significant. There has always been a tension as to which court should determine the bankruptcy issues: the Family Court or other courts such as the Supreme Court or the Federal Court. One of the amendments proposed in the Bill would give the Family Court exclusive jurisdiction to deal with concurrent bankruptcy and family law proceedings. This is a welcome change for family lawyers and their clients. Bankruptcy trustees,

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however, will be disappointed with the change and will view the proposed amendments as a win for the family over creditors.

Bankruptcy trustees' apprehension about being drawn into the Family Court may be warranted. Most people try to avoid that court! Bankruptcy trustees have been thrown in. Most of them have never been before a Family Court judge and would not be aware how those judges will balance the interests of the family versus the interests of the creditors. Most Family Court judges do not have the experience that judges in the Supreme Court or the Federal Court have in respect of bankruptcy law. It is uncharted territory for the majority of trustees and Family Court judges.

The current law

Under the current law, Family Court proceedings could not be commenced by a spouse in the event that the other spouse is bankrupt. In cases where at the time of the parties separation, one spouse is bankrupt, the non-bankrupt spouse has had to fight for their rights to claim part of the property of the bankrupt spouse in the Supreme Court. The non-bankrupt spouse has to prove that they made financial contributions to the acquisition or improvement of a particular property, before the Supreme Court, in its equitable jurisdiction, would make order that a part of the property (equal to the amount of the financial contributions made) be transferred to the non-bankrupt spouse. If the non-bankrupt spouse does not establish the financial contributions made, the application is dismissed.

The proposed changes

The amendments proposed in the Bill are a significant departure from the current position outlined above. The proposed amendments will allow non-bankrupt spouses to make an application for property settlement under the *Family Law Act 1975* in the Family Court, even though their spouse was bankrupt or was a debtor subject to a personal insolvency agreement at the time the application is made. (In the event that a spouse becomes bankrupt during family law proceedings, the law has not changed in that those proceedings will continue). In those circumstances, the bankruptcy trustee will be joined as a party to the family law proceedings. At that stage, the property of the bankrupt spouse would have been vested in the trustee and therefore the non-bankrupt spouse will in effect apply for orders that they be entitled to part of the property vested in the bankruptcy trustee.

Trustee v non-bankrupt spouse - doing justice?

In altering the interests in property that has vested in the bankruptcy trustee, the Family Court will no doubt apply the same principles that it applies in all other family

law cases and will examine the contributions of the non-bankrupt spouse to the property (which has now vested in the bankruptcy trustee), their contributions to the welfare of the family, and their future needs. Overall, the Court has to ensure justice and equity between the parties. In the case of bankruptcy, the court will have to do justice and equity between non-bankrupt spouses and the bankruptcy trustee, as the bankrupt spouse cannot be heard in the proceedings (except perhaps in relation to superannuation).

One wonders how the Family Court will balance the interests of the creditors in respect of the property that has vested in the bankruptcy trustee and the non-bankrupt spouse? What will be the asset pool that the Court will seek to settle where the liabilities exceed the assets? Will the Family Court ignore part of the liabilities of the bankrupt in order to effect a property settlement in favour of the non-bankrupt spouse? How will the Family Court assess the non-bankrupt spouse's non-financial contributions as well as the homemaker and parenting role?

In most family law proceedings where one of the spouses has been the financial activist during the course of the marriage and the other spouse was a homemaker and parent, the Family Court assesses the contributions of each of the spouses at 50/50 (notional division) and then pursuant to sec 75(2) (the future needs factors) the Court adjusts the notional division by reason of a number of factors including the health and income earning capacity of the parties, the care of the children, and the payment of child support. The homemaker spouse generally receives an adjustment in their favour by reason of the sec 75(2) factors.

Will the Family Court follow the line of authority in the Supreme Court or assess contributions and future needs in the same way as it does in non-bankruptcy cases? If the answer is yes, this will be a significant departure from how the Supreme Court deals with non-bankrupt spouses and their contributions.

Super-splitting - making up the difference?

There is a further layer of confusion in all of this, namely superannuation, which does not form part of bankruptcy and therefore does not vest in the bankruptcy trustee, However under the *Family Law Act* it could be split between separating spouses. In the event that the Family Court, say, orders 50% of the bankrupt's assets in favour of the non-bankrupt spouse, will the Court make up the adjustments that it would have otherwise make in favour of the non-bankrupt spouse by ordering a significantly higher percentage split of the superannuation entitlement of the bankrupt's spouse? Will the Family Court adjourn the proceedings until after the

bankrupt spouse has been discharged from bankruptcy and then deal with the superannuation split?

The *Marriage of L* (unreported decision of *Moore J* January 2003) was the first superannuation splitting case that was heard and determined by the Family Court following the commencement of the superannuation splitting law under the *Family Law Act*. The writer acted for one of the parties in that matter. Justice *Moore* was of the view that the wife was entitled to 50% of the husband's superannuation. However in doing justice and equity between the parties, given the wife's need for immediate cash to re-house herself and the parties' children, *Moore J* ordered that the wife receive 20% of the husband's superannuation and made up the balance due to the wife by giving her a higher percentage of the other assets. It is therefore open to the Family Court to increase the superannuation split of a bankrupt spouse's superannuation in favour of the non-bankrupt spouse so that the Court can do justice and equity between the parties.

Spouse maintenance

In addition to property settlement, spouse maintenance could also prove a nightmare for bankruptcy trustees and their creditors. The Bill provides that a non-bankrupt spouse may make an application for spouse maintenance, notwithstanding, that at the time the application is made, a party was bankrupt or became bankrupt during the proceedings. There is nothing unusual about proceedings continuing after a spouse becomes bankrupt, however, the first part, where a non-bankrupt spouse can commence spouse maintenance proceedings after a spouse becomes bankrupt, is a significant departure from the current law.

Spouse maintenance is one of the cornerstones of the *Family Law Act*. The Act provides that parties to a marriage must support each other financially in so far as they can do so. In determining whether spouse maintenance is payable, the Family Court examines two matters: whether a party has a need for spouse maintenance and, if the need has been established, whether the other party has the capacity to pay spouse maintenance. Pausing there, one wonders how a bankrupt could, even if the need threshold is established, afford or have the capacity to pay spouse maintenance?

The Bill provides that the liability of a bankrupt party to a marriage to maintain the other party may be satisfied, in whole or in part, by way of transfer of vested bankruptcy property in relation to the bankrupt party if the Court makes an order for the transfer. That is, the Family Court has the power to order that a property of a

bankrupt spouse, which has vested in the bankruptcy trustee, could be transferred to provide spouse maintenance for the non-bankrupt spouse.

Spouse maintenance could be applied for at any time during the course of the proceedings (interim spouse maintenance) or as a final order (final spouse maintenance order). There is a potential for the Court to order interim spouse maintenance by making an order for the transfer of a property that has vested in the trustee. At the final hearing of the matter, the court will still have to divide the balance of the assets then remaining amongst the non-bankrupt spouse and the creditors. The Court could also order final spouse maintenance from the available property. The effect of such orders for spouse maintenance is to reduce the property pool available for distribution amongst the creditors.

Financial agreements - riches to rags

The third significant change proposed in the Bill is to close the gap on people using Binding Financial Agreements (BFAs) as a measure of "asset protection". On 27 December 2000, the *Family Law Act* was amended to enable parties to enter into a BFA. BFAs can be entered into before or during the parties' marriage, or after dissolution of the marriage.

No one anticipated that the amendments made could create enough controversy to attract the Australian Securities and Investments Commission's (ASIC's) interest in family law or for ASIC to bring an action in the Family Court seeking to set aside a BFA made between Jodie and Maxine Rich, coincidentally, on the eve of the collapse of One.Tel.

When the Government introduced the amendments in December 2000, it had in mind one thing, namely to ensure that parties in family law cases could oust the jurisdiction of the court and therefore provide parties with certainty as to their financial arrangements following their separation. The government was interested in giving parties to a BFA certainty as to outcome. In this way, BFAs afford a good measure of asset protection, especially for parties who are about to be married and have significant wealth that they do not want to share with their loved ones if they separate down the track, or those parties who want to protect the family farm which has been in the family for generations, or to exclude a business from a division of assets (particularly if there are other parties involved).

It was not envisaged when the new amendments came in on 27 December 2000 that parties could enter into BFAs which would have the effect of reducing one's assets and removing them from claims by third parties. The case of *ASIC v Rich & Rich*

(2003) 93-171 has brought this issue home. In that case, ASIC applied to set aside a BFA entered into on 31 May 2001 by Jodee and Maxine Rich. Jodee and Maxine were still married. Because of the way the *Family Law Act* was structured at that time, which has since been remedied following the decision, the Family Court did not have the jurisdiction to set aside the BFA. Third parties including government instrumentalities (like ASIC) and creditors can now apply to set aside BFAs entered into with a view to defeat or defraud creditors.

When BFAs became part of the *Family Law Act*, an amendment was made to the definition of "maintenance agreements" in the *Bankruptcy Act 1966*. Section 5 of the *Bankruptcy Act* defines "maintenance agreements" to include "a financial agreement within the meaning of the *Family Law Act 1975*". Under the current law, a BFA affords protection under bankruptcy. It should be noted, however, that if a party enters into a BFA for the purpose of defeating or defrauding creditors, then, the creditors or ASIC or any other government instrumentality can apply to set aside the BFA.

The amendment proposed in the Bill provides for BFAs to be excluded from the definition of "maintenance agreements" in the *Bankruptcy Act*. The effect of the proposed amendment is that if parties had in the past or will in the future enter into a BFA, where the effect of the BFA is to render a spouse bankrupt by reason of the assets that the bankrupt spouse provide for the other spouse, that BFA will be set aside.

Further, because BFAs will no longer form part of the definition of "maintenance agreements", they will attract sec 120 of the *Bankruptcy Act*. Section 120 provides that any transfer of property below market value is an undervalued transaction and, therefore, could be attacked and clawed back by the bankruptcy trustee. A transfer between spouses for no consideration is an undervalued transaction. A transfer for love and affection is also an undervalued transaction. The exclusion of BFAs from the definition of maintenance agreement will apply to all bankruptcies current on or after the commencement of the Bill.

Some what ifs ...

- What about the situation where parties have already entered into a BFA not for the purposes of defeating or defrauding creditors but for a genuine purpose of providing certainty in the event of their separation?
- What will happen if one of the spouses then becomes bankrupt, the parties separate and the non-bankrupt spouse insists on their rights under the BFA? It is clear that the bankruptcy trustee would apply to set aside the BFA on one of two

grounds, namely, that the BFA was entered into for the purposes of defeating or defrauding creditors or as an undervalued transaction under Section 120. How will the Family Court deal with that situation? Will the Family Court set aside the BFA as an undervalued transaction or will the Family Court uphold the BFA?

- How can the Family Court conclude that a BFA which provides for a spouse to receive certain property on separation and in circumstances where the parties have conducted their married life on that basis be an undervalued transaction?
- How can the Family Court find that the homemaker and parenting role provided by the non-bankrupt spouse is an undervalued transaction? Certainly, if the BFA provides that the non-bankrupt spouse receives say 90% of the assets, then that would be seen as an undervalued transaction. But what if the BFA provides for the spouse to receive say 60%, which on all accounts is within the range of orders the court would have otherwise made?

If the Family Court sets aside the BFA, the Court will then deal with the non-bankrupt spouse's application for property settlement and spouse maintenance under the *Family Law Act*.

This is an area where the clash between the bankruptcy and family law will be at its highest point because on the one hand the *Family Law Act* encourages parties to enter into BFA's so that they can provide certainty of outcome and oust the jurisdiction of the Family Court and at the same time the Family Court will be entrusted with looking after the interest of creditors and therefore have to deal with and apply the *Bankruptcy Act*. The clash is of significant importance and the early cases will set the scene as to whose interests the Family Court will uphold.

Conclusion

The stakes are high and the clash will be a battle between David and Goliath, as bankruptcy trustees will want to ensure that the Family Court will uphold sec 120 of the *Bankruptcy Act* and will bring in the best silks to argue the case, whereas non-bankrupt spouses, with perhaps limited funds, will argue that the Family Court should uphold the BFA. It would be in the interest of justice for all parties concerned in those early cases for the Federal Government to provide funding to non-bankrupt spouses with limited funding to represent themselves.

The Bill will have far reaching implications on the way bankruptcy and family law will apply when they clash. Trustees may argue that the pendulum will swing in favour of the family and against trustees. Family law lawyers will argue that the pendulum will swing in favour of trustees and against the family, especially in the area of BFAs. Only time will tell where the pendulum will finally rest.

