

Is this the end of asset protection?

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CCH Feature Article

The Federal Government is proposing significant reforms to the *Bankruptcy Act* and *Family Law Act*. Squarely within the government's sights are bankrupts who are still able to enjoy the benefit of assets acquired with their money or effort, by arranging their affairs in such a way that the assets are not held in the bankrupt's name.

For a long time this has been the basis of much financial planning and "asset protection" advice. However, as **Stephen Mullette**, Associate with The Argyle Partnership, explains in this article, the proposed legislation represents a "fundamental shift away from the perceived legitimacy of these arrangements", according to Attorney-General Philip Ruddock.

Although the reforms represent a significant change in the existing law in this area, there is some question over whether they will achieve all of the government's objectives.

A tale of two cases

The proposals respond to a report of "The Joint Taskforce On The Use Of Bankruptcy And Family Law Schemes To Avoid Payment Of Tax". However in political terms, the proposed legislation respond to two recent "asset protection" cases. The first involved a bankrupt barrister, John Cummins (*Prentice v Cummins* [2002] FCA 1503), and the second involved a non-bankrupt company director, Jodee Rich (*ASIC v Rich* (2003) FLC ¶93-171; [2003] Fam CA 1114)

Cummins' case

Mr Cummins had been a barrister since 1961 and a Queens Counsel by 1980. Notwithstanding this, Mr Cummins had failed to lodge a single tax return for some 45 years. There was evidence of significant income averaging over \$330,000 in the 8 years prior to his bankruptcy. Nevertheless, on bankruptcy Mr Cummins had few valuable assets. His most significant assets, a property at Hunters Hill and shares representing his Sydney barristers chambers, had been transferred by him to his wife and a family trust respectively, in 1987, more than 13 years prior to the date of his bankruptcy. The only significant asset left in his name was an interest in some chambers in Parramatta, that Mr Cummins' solicitor had inadvertently forgotten to transfer along with the other assets.

Although the transfers were said to be for valuable consideration none was found to have been paid. As a result, the Court was able to find that the assets had been transferred in breach of the existing provisions of the *Bankruptcy Act*. The case, however, highlighted some difficulties facing bankruptcy trustees in proving their case. For instance, in the absence of records of what Mr Cummins earned at the time of the transfer and without the tax returns he had failed to lodge, Mr Cummins argued that the trustee had failed to prove there was a creditor he had been trying to avoid! Notwithstanding this, the Court was able, in the extreme circumstances of that case, to conclude that there was no other purpose for Mr Cummins transfers in 1987 of almost of his significant assets, than a desire to defeat

the ever increasing liability he would ultimately have to pay to the Tax Office.

The Rich Case

Jodee Rich may be thanked for his significant contribution to the development of Family Law and Bankruptcy Law in Australia. This is perhaps a little surprising when it is remembered that he is neither a bankrupt, nor separated from his wife. Nevertheless, at the time One.Tel Limited was collapsing, and in fact the day after voluntary administrators had been appointed, Jodee and his wife Maxine decided to enter a binding financial agreement under the provisions of the *Family Law Act*. This had the effect of transferring several millions of dollars of assets from Jodee to Maxine. This was because, so it was said in the agreement, "Jodee's financial affairs have taken a significant turn for the worst and his financial future is under a cloud". As a result of a financial agreement, Jodee's assets of approximately \$9.5m were reduced to \$3.9m, and Maxine's already substantial assets of approximately \$13m were increased to \$16.5m.

The other significant event occurring on 31 May 2001, the same day the binding financial agreement was signed, was the launch of an ASIC investigation into the affairs of One.Tel, including possible breaches of Corporations Law by Jodee Rich. This led to proceedings being commenced against Mr Rich by ASIC for around \$93 million. On learning of the binding financial agreement, ASIC went to the Family Court seeking that it be overturned. Despite expressing sympathy for the claim by ASIC, (and concern at the role of their advisers) the Judge in the *ASIC v Rich* case was unable to assist ASIC. The Family Court simply did not have jurisdiction to entertain a claim by a third party (such as ASIC) where there were no current listing Family Court proceedings.

Following the *ASIC v Rich* case, the government acted swiftly to rectify the situation and passed legislation granting jurisdiction to the third party creditors and the government agencies in the Family Court. However, the proposed reforms build on this jurisdiction and are put forward as enabling concurrent bankruptcy and Family Law proceedings to be brought together.

In both the *Cummins* and *Rich* cases, asset protection strategies were employed to preserve the benefit of significant assets from the reach of creditors. In the one case, this was through the use of Family Law arrangements and in the other, the transfer of assets out of the bankrupt's name. The government's proposed reforms attack both strategies.

The reforms

There are four areas of reform:

1. Changes to the *Bankruptcy Act* to allow a trustee to attack a binding financial agreement.
2. Changes to the *Family Law Act* and *Bankruptcy Act* to allow the Family Court power to deal with bankruptcy matters when they interact with a Family Law case.
3. Changes to the income contribution regime to allow a bankruptcy trustee power to control how much money a bankrupt receives from his or her own income.

4. Replacement of Div 4A of Pt VI of the *Bankruptcy Act* to enable a bankruptcy trustee to attack assets still being enjoyed by a bankrupt.

Binding financial agreements

One of the most radical recent developments in asset protection has been the introduction of the binding financial agreement. Originally intended as a way to simplify Family Law property disputes, the binding financial agreement allows spouses and intending spouses to transfer property without fear of challenge by a bankruptcy trustee. This is because binding financial agreements fell within the definition of "maintenance agreement" in the *Bankruptcy Act*. Maintenance agreements are prevented from challenge by a bankruptcy trustee certain of the "claw back" provisions of the *Bankruptcy Act*. These provisions enable the recovery of assets transferred by a bankrupt in certain circumstances.

The proposed legislation will close the binding financial agreement loophole. The amendments will exclude binding financial agreements from the definition of "maintenance agreement" in the *Bankruptcy Act*. This will mean a bankruptcy trustee may challenge a binding financial agreement as an undervalued transaction, a transaction to defeat creditors, or even as a transaction which has a preferential effect, in the same way that any transfer of assets by the bankrupt to a third party may be challenged.

In addition, a person will commit an act of bankruptcy if a binding financial agreement is signed which has the effect of making the person insolvent. This may affect the date the bankruptcy is deemed to have commenced, and therefore, what assets are available to creditors.

Interaction of Bankruptcy and Family Law Proceedings

It has been difficult for some time in attempting to co-ordinate Family Law and bankruptcy proceedings.

A bankrupt may have transferred assets by consent orders (or binding financial agreements) in the Family Court. A person may enter bankruptcy to defeat the interests of his or her spouse in Family Law proceedings. In either case, this can lead to confusion, multiple proceedings, additional costs and delays. This situation is being used by the less scrupulous bankrupt/spouse to delay or defeat the legitimate interests of creditors or family.

The exposure draft proposes some significant reforms to the interaction of bankruptcy and Family Law.

The draft legislation provides for the almost exclusive jurisdiction of the Family Court whenever there are Family Law proceedings. For the first time a spouse of a bankrupt will be able to continue or commence a property or spousal maintenance claim against the bankrupt even where all of the assets have vested in the bankruptcy trustee. If successful, the assets will be removed from vesting in the bankruptcy trustee and will not be available to creditors. A trustee may in certain circumstances be involved in the Family Court proceedings, and the legislation introduces an additional factor for the Family Court to consider before making any orders adjusting property interests, that is, "the effect of any proposed order on the ability of a creditor of a party to recover the creditor's debt".

This change will shift the existing conflict - between the interests of creditors and the needs of family - onto the Courts to decide, without any clear direction as to how that conflict is to be resolved. The Family Court will still be presented with the competing interests of creditors and families and asked to exercise its discretion as to who should receive the limited assets available. Nevertheless, by selecting the Family Court as the forum for resolving this dispute (rather than, say, the Federal Court which is more familiar with bankruptcy matters), the government has adjusted the balance of power between these competing interests in favour of the family.

The most significant aspect of this change therefore passes without comment in the proposed legislation or the explanatory memorandum. This is the basis for the shift in power between the interests of creditors and family. It is surely right to say that both interests need to be protected. It is perhaps true to say that at present the interests and contributions of the bankrupt's spouse are not adequately recognised in the distribution of the bankrupt's assets. However in the absence of any clear guidance from the government as to the rationale behind the proposed changes, the competing interests of creditors and spouses will be left to the Family Court to decide.

If one thing is clear it is that bankruptcy trustees will rapidly need to develop experience in property and spousal maintenance proceedings in the Family Court.

Income contributions

The exposure draft proposes a new regime for the supervised collection of a bankrupt's income. Instead of a bankrupt being liable to account to his or her trustee for the income contributions above the threshold amount, a bankruptcy trustee may require the bankrupt to pay his or her entire income into a supervised account. The bankrupt may then be entitled to receive amounts from the trustee to live on. This change is to make it easier for a trustee to collect a bankrupt's income contributions, and to hold a bankrupt accountable for income contributions which become payable.

This "supervised account regime" will only apply where in circumstances where the bankrupt has not been meeting his or her contribution obligations and a trustee gives notice of his or her determination that the regime will operate. Where it operates, a bankrupt must open a separate bank account to which all income is to be deposited within five days of receipt of cash or cheques, and, in the case of credit card or electronic payment, immediately. Further, "income derived by the bankrupt" must no longer be paid in cash, or dealt with so that it is not actually received by the bankrupt. One wonders whether this begs the question somewhat, since unless a trustee can prove that income derived by the bankrupt has been siphoned off to related entities, the penalty provisions of the regime will not apply. One exception which may generate some interesting debate is in relation to "cash refunds" paid from income, before the income is deposited to the supervised account.

That said, the new regime is given some significant "teeth" with penalties ranging from six to 12 months' imprisonment for breach. Additionally, powers are given to the trustee to obtain injunctive relief where it appears the bankrupt is proposing to breach the regime. Significantly, in granting interim injunctions the Court cannot require the trustee to give the usual undertaking as to damages. Nor can a Court refuse to give an injunction because there is no indication that a bankrupt is likely to re-offend; or because there is no immediate danger of anyone suffering substantial damage because of

the bankrupt's conduct. It seems that the government is encouraging the use of these injunctions for minor breaches of the regime, and whether or not the breach is likely to recur. Against this it is noted that the injunctive relief is limited to the bankrupt, and in respect of conduct by the bankrupt. It would have been more useful to have some clearly stated powers to take steps where actions by third parties, such as employers or contractors, are likely to cause the bankrupt to breach the regime.

Replacement of Div 4A of Pt VI *Bankruptcy Act*

As mentioned above, the exposure draft proposes to replace the entirety of Div 4A of Pt VI of the *Bankruptcy Act*. If you had not heard of this Division, you are not alone. There have been virtually no cases that have considered these provisions. It has still been largely possible for a bankrupt to enter arrangements where his or her income or property are held in someone else's name, yet still enjoyed by the bankrupt.

In para 16 of the explanatory memorandum to its exposure draft, the government has indicated: "a fundamental shift away from the perceived legitimacy of these arrangements. Although the arrangements may continue to be legitimate for other purposes, the government does not believe that these assets should remain protected where creditors' claims cannot be met from assets held in the bankrupt's name whilst the bankrupt continues to enjoy a lifestyle effectively funded by his or her own means".

The existing regime requires a bankruptcy trustee to demonstrate (sec 139D):

- that an entity is "controlled" by the bankrupt;
- that a bankrupt supplied personal services to the entity during the period between two and four years before commencement of the bankruptcy; and
- that the bankrupt derived a benefit from the property

Alternatively, a trustee can demonstrate that (sec 139E):

- the entity was controlled by the bankrupt;
- the services supplied by the bankrupt were "substantially" underpaid; and
- the net worth of the entity substantially increased as a result of the services supplied by the bankrupt, beyond what might "reasonably be expected" had the services not been supplied.

Concepts such as "control" and "substantially" and the limited time frame considered by these sections, have meant they have not been seriously utilised.

The government proposes to replace this entire Division with a new Div 4A. Interestingly, the government abandons the neutral language of the previous division, and perhaps in a move designed to counter the decreasing stigma of bankruptcy, has littered the proposed new part with references to "tainted" purposes, "tainted" property and "tainted" money. How the Courts will interpret the moral tenor of the proposed legislation is uncertain.

"Tainted property" and "tainted money"

There are three key elements to tainted property/money:

1. The creation or transfer of an asset. This can be:
 - a. By transfers which take place through a series of entities, or as part of a "scheme";
 - b. Property which has been bought, sold, and the proceeds used to buy other properties;
 - c. Acquired by reason of the bankrupt performing work (for instance a service entity) at an undervalue; or
 - d. An increase in value of property because a mortgage has been discharged or reduced by the bankrupt;
2. A "tainted purpose" in the creation/transfer; and
3. A benefit derived by the bankrupt, whether directly or indirectly, from the property/fund;
4. Creation /Transfer of Assets

It can be seen that the definition of what will be a transaction caught by the new Divi 4A is extremely broad. It will include everything from the issue of shares to the payment of a mortgage. It gives rise to an ability of a bankrupt's trustee to trace through a series of transactions, where an asset has been sold, the funds used to acquire another asset, which has also been sold, and so on. Alternatively, an asset passing through a number of interposed entities will also be caught, provided the other elements can be made out. At the very least, a series of entities involved in transferring an asset down the line could constitute a "scheme" for the purposes of the legislation.

Tainted Purpose

The bankrupt will have a "tainted purpose" where his or her main intention is to defeat or delay property becoming available to creditors; or where it may reasonably be inferred from all the circumstances that the bankrupt was about to become insolvent.

The intention test is the same as the "clawback" provision in sec 121(1) and (2) of the *Bankruptcy Act*. The explanatory memorandum says that this is deliberate (para 46).

What is significantly different from the existing law is the onus of proof, which will now rest on the entity which has received the property/money. Under proposed sec 139 AFA(2) and (4), a trustee in bankruptcy must merely allege that the bankrupt had a tainted purpose. The Defendant then must prove the "contrary". It is this presumption that, according to the Explanatory Memorandum, reflects "the Government's commitment to challenge the legitimacy of asset protection upon bankruptcy" (EM at para 49). Because of the way it is presently worded, the legislation requires that the defendant to an action by a bankruptcy trustee prove not only that there was a main purpose other than defeating or delaying creditors, but also that the bankrupt was solvent at the time the transfer took place.

The catch-22 of the reverse onus is that the more genuine a transaction is, the harder it will be for the defendant to satisfy the test. Where an innocent third party has ended up with assets which were originally owned by the bankrupt, co-operation will be required from the bankrupt to demonstrate the bankrupt's real main purpose, and to prove that the bankrupt was solvent at the time. The more distance between the bankrupt and the owner of the asset being sued, the less reason the bankrupt has to willingly provide this information.

Benefit

Benefit is defined to include both "direct" and "indirect" benefits. The existing Div 4A simply refers to "benefit" and so the government is making it clear that it wishes a broad interpretation of benefit to apply. Beyond this, however, what constitutes an indirect benefit is anyone's guess. No guidance is given in the legislation or the explanatory memorandum. In *Sheahan v Birdseye* [2002] FMCA 41, one of the few cases under the existing regime, Federal Magistrate *Raphael* held that Mr Birdseye (the bankrupt): "enjoyed the benefit of some of the moneys [which he earned] used for Mrs Birdseye's personal expenditure. He would have enjoyed the flowers at their home. He would have enjoyed the meat that was put on their table" (at [45]).

How much further the new definition will extend beyond this already wide interpretation remains to be seen.

Exemption

There is a defence for an "exempt full-value transfer". This is where a transfer involves payment of market value consideration and either the transferee did not know the transferor's main purpose, or the transfer took place more than ten years ago.

A radical change?

At the end of the day, and putting to one side the reversal of the onus of proof of the bankrupt's purpose, it is questionable how much further the amendments take the powers of a bankruptcy trustee. Certainly there is a radical departure from the existing Div 4A, and these improvements will be welcomed by bankruptcy trustees. However there are only minor changes when compared with the existing sec 121 powers of the trustee to attack transfers with the purpose of defeating creditors. There is also an additional element the trustee must make out, namely the requirement that the bankrupt has retained a benefit from the assets in question.

Further, even should the trustee make out all of the relevant criteria, the new regime gives discretion to the Court not to recover the assets for the benefit of creditors. The amendments list a set of relevant factors a Court must take into account in considering whether or not to make any orders about the property. These include, for instance, whether the person being sued by the trustee will be able to pay his or her own creditors, if the assets are transferred. How the Courts will exercise this discretion and weigh up the competing interests of creditors of the bankrupt against creditors of the defendant, remains to be seen.

Conclusion

The exposure draft of the proposed amendments runs to some 70 pages. The legislation may or may not ultimately find its way into law. The likelihood however, is that given the recent spate of high-profile asset protection arrangements that have come under attack, the government will implement reforms of some kind. The present proposals have four main elements:

1. Financial Agreements will no longer be an immune form of asset protection and may be the subject of an attack by a bankruptcy trustee as with any transfer of property;
2. Bankruptcy trustees will need to brush up on their Family Law as they participate in property/spouse maintenance proceedings in the Family Court.
3. A new regime in relation to income contributions will make it harder for a bankrupt to withhold income contributions from his or her trustee; and
4. Bankruptcy trustees have a powerful but limited weapon in seeking to recover assets transferred or created by bankrupts who continue to use or enjoy their benefits.

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