Bankruptcy – protecting death benefits and insurance

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Mercies of the *Bankruptcy Act 1966* and *Life Insurance Act 1995* that should be wider known and utilised.

Personal bankruptcy results when an individual is unable to pay his or her debts as and when they fall due and payable.[1] Notably, the test is not whether the debts exceed an individual's assets, it is whether the individual's income permits the payment of the outstanding debts.

When an individual's income is insufficient to pay the debts, and in extreme cases where a trustee in bankruptcy has been appointed, the individual's assets are sold to pay the creditors.

Not all assets are available for the sale and payment of the debts of solvent and bankrupt individuals.

Sections 204 and 205 of the *Life Insurance Act 1995* (Cth) provide that insurance proceeds on one's own life or on the life of a spouse or de facto partner are not available for payment of debts, unless so specifically charged with the payment of debts. The proceeds can, however, be used for the payment of funeral and testamentary expenses.[2]

These provisions of the *Life Insurance Act 1995* are concerned with solvent individuals and estates, and are subject to the provisions of the *Bankruptcy Act 1966*. The mercy of the *Bankruptcy Act 1966* is that it mirrors those provisions for bankrupt individuals and insolvent estates.

Section 116(2) of the *Bankruptcy Act 1966* contains a list of assets not divisible among creditors on an individual's bankruptcy, for example, household items, items of sentimental value, property which is necessary for the bankrupt to earn an income, a basic vehicle, compensation paid as a result of a personal injury[3] or death of the bankrupt, their spouse or de facto partner or a member of their family, assets held in trust for the individual by another etc. Importantly for this column, subsection (2)(d) protects insurance policies on the life of the bankrupt or the spouse or de facto partner of the bankrupt received on or after the bankruptcy, as well as superannuation of the bankrupt held or received on or after bankruptcy.

These provisions are often overlooked by practitioners and do not often come up for judicial comment. However, these provisions exist to assist clients who are nearing rock bottom and should be utilised more often for that reason.

A recent case of *Trustees of the Property of Morris (Bankrupt) v Morris (Bankrupt)*[4] reminds us about the benefits of these provisions.

Debbie Morris' circumstances were tragic. All in the same year, she gave birth to a baby, her husband went bankrupt, her husband died leaving her alone with the baby and a two-year-old, and she is declared bankrupt herself.

Her husband left three superannuation and life insurance products:

- $311,865.93 of life insurance and related anti-detriment adjustment payment with Plum Super;
- $45,392.48 of superannuation with AustSafe Super; and
- $67,240.27 of superannuation with Plum Super.

After the tragic events, receipt of almost $430,000 would, no doubt, have been a welcome opportunity for a new start by Debbie.

Her trustee in bankruptcy accepted that the first payment of $311,865.93 was not available for payment of creditors as it was a life insurance policy clearly falling within s 116(2)(d).

The trustee pursued the two payments of $45,392.48 and $67,240.27 because they were paid to Debbie well after her husband's death as a result of the super fund trustees exercising their discretion to pay the death benefits to her as her husband's dependant in the absence of death benefit nominations.

The bankruptcy trustee contended that because there were no nominations, the exercise of the super fund trustees' discretion had the result of creating Debbie's interest while she was a bankrupt and was therefore after acquired property[5] for the purposes of the *Bankruptcy Act 1966,* and not subject to the protection of s 116(2)(d)(iii)(A) and (iv), which protect superannuation.

The bankruptcy trustee submitted that once the interest was created, it vested in Debbie's trustee in bankruptcy and became divisible among her creditors. In effect, the bankruptcy trustee was saying that the superannuation should not be protected because it was the husband's and not Debbie's. The bankruptcy trustee argued that the *Bankruptcy Act 1966* specifically refers to life insurance of the spouse or de facto partner being protected, and this is deliberately different from the wording used with respect to superannuation, "the interest of the bankrupt in …" superannuation, this distinction leading to the conclusion that only the bankrupt's own superannuation is protected from creditors, not the spouse beneficiary's.

Debbie asked the court to construe the payments as superannuation within the meaning of s 116(2)(d)(iv) in that her husband was a member of the super fund and she became a member in his place.

Logan J acknowledged that the super fund trustees could have exercised their discretion and paid the death benefits to

Debbie's children or her husband's estate, or to the four potential recipients in various proportions at their discretion. He also acknowledged that, until the discretion was exercised, Debbie had no rights towards the superannuation other than a right to be considered and of due administration.[6] Accordingly, Logan J held that between the date of death of Debbie's husband and the date that the super fund trustees exercised their discretion to pay the death benefits to Debbie, Debbie had no interest within either fund within the meaning of s 116(2)(d)(iii)(A). On the super fund trustees exercising their discretion in her favour, her interests in the super funds were created and immediately on creation were captured by s 116(2)(d)(iii)(A) and, therefore, were immediately protected.

Logan J said at [30]:

> "Parliament, in my view, ought to be taken to have been cognisant in the reference to the [Superannuation Industry Supervision] Act in s 116(2)(d)(iii)(A) of the breadth of persons who under that Act can constitute a beneficiary …
>
> There is another path to exemption in respect of each of the payments in that they are literally payments to the bankrupt, in terms of s 116(2)(d)(iv), from a regulated superannuation fund. Again, that breadth of reference rather looks to be a recognition by Parliament of the breadth of persons who may receive payments from superannuation funds. In other words, it is a recognition that the breadth of persons extends to those who are members of funds, as well as to their spouses and their dependents."

In a small mercy to Debbie, Logan J dismissed the trustee's application and ordered the bankruptcy trustee to pay Debbie's costs of, and incidental to, the application.

It should be noted that, if the superannuation and life insurance had been paid to Debbie's husband's bankrupt estate, these proceeds would have been protected under s 249 of the *Bankruptcy Act 1966* which replicates s 116 for deceased estates.

Conclusion

It is uncontentious that insurance proceeds on the life of the bankrupt or their spouse or de facto partner are protected from payment of debts of the bankrupt or of the bankrupt spouse or de facto partner.

It is also uncontentious that superannuation of the bankrupt is protected from payment of debts of the bankrupt (whether alive or deceased), provided there has not been any fraud or deliberate contributions to superannuation to avoid creditors.[7]

Logan J's decision confirms that superannuation of a deceased is protected from payment of debts of the bankrupt spouse or de facto partner.

This invaluable clarification draws attention to the following:

- a person who has met a condition of release and who is facing bankruptcy should take extreme care in how their superannuation is handled, because withdrawing it from the superannuation environment as a lump sum could expose it to the trustee in bankruptcy and make it available for payment of creditors, whereas drawing a steady modest pension would not;
- a bankrupt who has met a condition of release who withdraws a lump sum from superannuation will not lose it to their trustee in bankruptcy;
- the overarching purpose of superannuation death benefits continues to trump all else — providing for dependants of the deceased member even if they are bankrupt. Superannuation succeeds as the asset protection strategy of our time;
- as the Commissioner of Taxation and trustees in bankruptcy become more aggressive in their collection strategies, superannuation appears one of the last undefeated fortresses;[8]
- practitioners drafting wills should consider incorporating clauses in wills directing the personal representatives of estates to keep life insurance and superannuation benefits separate from the other estate assets and not to apply them for the payments of debts;
- personal representatives of all estates should take particular care to quarantine life insurance and superannuation benefits from the other estate assets to ensure they do not inadvertently use these funds to pay creditors; and
- there is nothing like a binding death benefit nomination! If Debbie had been named in a valid binding nomination at the date of her husband's death, this case would have had no reason to ensue, saving Debbie time, stress and costs.

In every case, practitioners should turn their mind to the benefits of binding nominations.

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References

1 S 5(2) of the *Bankruptcy Act 1966* (Cth).
2 *Re McCallum; Baird v McCallum* (1907) 7 SR (NSW) 523.
3 See the recent case of *Berryman v Zurich Australia Ltd* [2016] WASC 196.
4 [2016] FCA 846.
5 S 58 of the *Bankruptcy Act 1966*.
6 As per *Sainsbury v Inland Revenue Commissioners* [1970] Ch 712 at 725.
7 *Cook v Benson* [2003] HCA 36.
8 *Denlay v FCT* [2013] FCA 307.