BANKRUPTCY

DEALING WITH

ASSETS

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September 2017

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1. Vesting of Property

1.1 General Rule

The general rule is that when a person becomes bankrupt, their property vests in their trustee (Bankruptcy Act s. 58 (1) (a). This means things they own pass into the ownership of their trustee. During the time the person is bankrupt, after-acquired property also vests in their trustee (s. 58 (1) (b). The general rule is subject to a number of exceptions.

1.2 Exceptions to the General Rule

There are a number of exceptions to this general rule, created by subsection 116 (2) of the Bankruptcy Act. That subsection lists a number of types of property that do not vest in the trustee for division amongst the creditors. They are referred to as “non-divisible” property, or more commonly as protected property.

2. Protected Property

2.1 The main categories of protected property are:

* property the bankrupt holds in trust for another person;
* ordinary household property, including some items of sentimental value;
* tools of trade to the value of $3,700;
* vehicles used by the bankrupt primarily as a means of transport to the value of $7,800;
* interests in life assurance, endowment insurance, superannuation and retirement savings accounts;

* damages and compensation for personal injury or wrong; and
* proceeds of some types of rural support schemes

3. Money

3.1 General Rule

The general rule is that money is not protected property.

3.2 Exceptions

There are some exceptions to this. Money from a claim for personal injury or wrong is protected, whether it is received before or after the person becomes bankrupt (s.116 (2) (g)). Money from a life assurance, endowment insurance, superannuation or retirement savings account received **on or after** the date of the bankruptcy is protected (s.116 (2) (d).

3.3 Money At The Date of Bankruptcy

The words 'date of the bankruptcy' are defined to refer to the date when the Official Receiver accepts a debtor's petition, or a court makes a sequestration order on a creditor's petition (s. 5).

As noted above, when a person becomes bankrupt all their property except protected property vests in their trustee. As money is generally not protected, it means that the money a person has at the date of the bankruptcy vests in the trustee.

If a bankrupt has a private trustee, that trustee may well require the bankrupt to hand over all the cash the bankrupt has, and take the proceeds of all bank accounts the bankrupt has.

If a bankrupt has AFSA as their trustee (the "Official Trustee") the approach is more generous. There is an Official Trustee Practice Statement on the AFSA website, entitled Application of Section 125 of the Bankruptcy Act 1966 Where Estate is Administered by the Official Trustee. This practice statement acknowledges that most bankrupts have few assets, and their bank accounts normally have low balances, and are used to receive payment of salary or government benefits. The thrust of the practice statement is that the Official Trustee does not require banks to freeze accounts where the balance does not exceed $2,000, and the account is used to receive predominantly personal income. If the account has more than $2,000, or it is a business related account, the bank has to comply with section 125. This means the bank must report the existence of the account to the trustee, and freeze the account, pending instructions from the trustee or a court.

What must be emphasized here is:

* this Practice Statement applies only if AFSA is the trustee. It is increasingly common for bankruptcies to be administered by private trustees, who are not bound by this statement; and

* this Practice Statement only relates to an account used predominantly for personal as opposed to business income. Any indication, for example the name of the account or the pattern of deposits which suggests it is not personal income may lead FSA to decline protection of it.

3.4 Money Received During Bankruptcy

There are two categories of money a bankrupt may receive during the bankruptcy. These are income, and other money received.

3.5 The Bankrupt's Income

Though the Bankruptcy Act does not make the income of a bankrupt protected property, the Act operates on a distinction between the property of a bankrupt, which largely vests in the trustee, and the income of a bankrupt which does not. Section 139 of the Act creates a regime of contribution by bankrupts from their income if their income is over a fairly generous figure, which is adjusted each year on 20 March and 20 September. The current Base Income Threshold Amount (BITA) is $55,446.30. This is net annual income after tax, and after any child support or maintenance is deducted. If the bankrupt has dependants, the threshold is increased by 18%, 27%, 32%, 34% or 36% for 1, 2, 3, 4 or more than four dependants. Income above the threshold is divided equally with the trustee. Other than this contribution requirement, the bankrupt's income stays with the bankrupt.

3.6 Other Money Received

Unless other money received by the bankrupt during bankruptcy is from a protected source, described in 3.2 above, it vests in the trustee. Common examples are lottery wins and inheritances. A person considering bankruptcy wisely takes this into account in their decision making. If a bankrupt is a discretionary beneficiary of a trust, including a trust created by will, they will only receive money if the trustee of the trust decides to make a payment to them.

3.7 Savings During Bankruptcy

The general principle, that a bankrupt's income does not vest in the trustee, means that a bankrupt's savings from income stay with the bankrupt. However, if the bankrupt buys other types of property with these savings, it is after-acquired property of the bankrupt which vests in the trustee, unless it is in a protected property category (s. 58 (1) (b)). For example, if a bankrupt buys a block of land

from their savings, the block of land vests in their trustee. If the bankrupt buys a $7,800 car for their daily transport, it will remain with the bankrupt as part of their protected property.

4. Houses

4.1 General Rule

The general rule is that houses are not protected property.

4.2 Exceptions

There are two exceptions to the general rule that houses are not protected property. The first is that property is protected to the degree that it has been bought with protected money. In this context, it is important to note that protected money is:

a) proceeds of a life assurance or endowment assurance policy received on or after the date of the bankruptcy;
b) a payment to the bankrupt from a protected superannuation fund received on or after the date of the bankruptcy;
c) damages or compensation for personal injury or wrong: and
d) certain sums received from some rural support schemes (s.116 (2) (n)

It is notable that some other categories of money which are protected in some situations are not protected in this context:

For example, money a bankrupt has received from a superannuation payment split ordered by the Family Court (s. 116 (2) (d) (iva), money from a Retirement Savings Account (s. 116 (2) (d) vi), and payments ordered by the Family Court to

be made to a former partner of the bankrupt (s.116 (2) (q) (r) are protected while they are money, but investments bought with that money are not protected.

The second exception is that property which is subject to a Defence Force mortgage or contract of sale has protection in some circumstances (Defence Service Homes Act 1918 (Commonwealth) s. 45A). This protection extends to a veteran's right to residence in a retirement village which is the subject of a contract of sale, mortgage or other security relating to a Defence Service Homes Corporation advance. Apart from these exceptions, houses vest in the trustee if the owner becomes bankrupt.

4.3 Sole Ownership and Co-ownership

A person may own a property in their name alone (sole ownership) or may own jointly or as tenants in common with another person or persons (co-ownership). Sole ownership is more straight forward in bankruptcy, as the bankrupt's interest simply passes into the ownership of the trustee (vests). The case of a joint tenant becoming bankrupt is more common.

4.3.1 Joint Tenancy

As part of the principle that the bankrupt's interests in property pass into the ownership of the trustee, the interest of a person in a property which they jointly own with a friend or family member also passes (vests in the trustee). The joint tenancy is dissolved when this happens, and the non-bankrupt co-owner and the trustee in bankruptcy then own the property as tenants in common (1).

In an ordinary situation, the trustee can then proceed to sell the interest of the bankrupt in the property. The trustee can invite the non-bankrupt co-owner to join him in selling the property, or the trustee may offer to sell the share which was the bankrupt's to the non-bankrupt co-owner. However, the trustee does not

have any power to compel the co-owner to spend money to improve the property, or the title to it (2).

5. Trustee In the Shoes of the Bankrupt

When a person becomes bankrupt, and their property other than protected property passes into the ownership of the trustee, the trustee generally takes the property as it is (3). One exception is that a trustee in bankruptcy does have a right to pay off a mortgage early (4). Bankruptcy does not affect the right of a secured creditor to realize or otherwise deal with its security (5). The fact that the borrower-mortgagor has become bankrupt does not, of itself, entitle the lender mortgagee to take any action (6). A trustee in bankruptcy has the right to disclaim onerous property, for example land that is not readily saleable (7). A trustee must act with due dispatch (8), and must administer the estate in the interests of creditors and in accordance with the Bankruptcy Act (9).

Putting these principles together, the most important consideration is the net value of the property. A property in which there is a sizeable equity will be dealt with differently from one in which there is little or no equity, or a negative equity.

5.1 House With Substantial Equity

If the bankrupt owned or had an interest in a house with a substantial equity, in accordance with the principles outlined above, the trustee will wish to sell the house, or the bankrupt's interest in it, promptly, and for the best price reasonably obtainable (10).

It is not in the interests of creditors for the property to be sold at a price which will create loss for the estate. Accordingly, the property can only be sold if the sale price is sufficient to pay out any mortgage or other encumbrance on the title, any outstanding rates or water rates, the real estate agent's commission on the sale,

the costs of the solicitor or settlement agent, and any other unavoidable expenses related to the sale. The costs of the sale will vary from one house to another, but $10,000 is a realistic minimum.

If there is a substantial equity in a house owned solely by the bankrupt, the trustee will set about placing the property on the market, as if it were a normal sale. If a friend or family member wishes to buy the property, and can raise the necessary money, the trustee may well be happy to sell to that person. It may save some of the costs of a sale by the usual methods.

After the mortgage and any other encumbrances are paid, and the costs of the sale, including the trustee’s costs are paid (including the realizations charge) the surplus remaining is credited to the estate.

If the bankrupt owned the property jointly with another person, as noted above the effect of bankruptcy is to dissolve the joint tenancy, and the trustee and the non-bankrupt person own the property as tenants in common (11). The trustee will ordinarily contact the co-owner, and invite them to buy the trustee’s half-share, or to join the trustee in a sale of the property. The co-owner should not underestimate the power of the trustee. The trustee has power to take possession of the bankrupt’s share of the property (12), and can start proceedings in the Supreme Court to compel a sale of the property (13).

5.2 House With Small or Negative Equity

As mentioned above, a trustee must administer a bankrupt estate in the interests of creditors, and it is not in the interests of creditors to sell a bankrupt’s interest in a property in a way which causes loss to the estate The trustee takes the property of the bankrupt, for most purposes, as it is. Accordingly, if there is a small or negative equity in a house, the trustee cannot sell the property on the open market. The normal practice is that the trustee will put a caveat on the title,

recording the trustee's interest. The trustee can then leave things for three years, and review the situation when the bankruptcy ends. If the equity is, by that time, substantial the trustee can sell the property on the open market. A friend or family member of the bankrupt can offer to buy the bankrupt's interest at market value.

5.3 Paying The Mortgage

As mentioned earlier, bankruptcy does not affect the right of a secured creditor to realize or otherwise deal with its security (14). If bankrupts do not pay mortgage payments, the lender can take action under the mortgage despite the fact that the borrower's interest in the property has vested in the trustee in bankruptcy.

If the bankrupt does continue to make mortgage payments, and otherwise complies with the terms of the mortgage, the lender is not able to take any action under the mortgage despite the bankruptcy (15).

5.4 Keeping the House

If a person owns a house in which there is a small or negative equity, and they are being pressed by creditors, they can petition in their bankruptcy, continue to pay the mortgage payments, but stop paying other creditors. Their trustee in bankruptcy will place a caveat on the title. At the end of the bankruptcy the trustee will review the situation. If the equity in the property is still small or negative, the trustee can offer to sell it to the bankrupt **after** discharge. The trustee will wish to sell the equity for a sum which covers the trustee's costs of the transaction.

The other important cost the former bankrupt needs to consider is the duty on a transfer of the property from the bankruptcy trustee to the former bankrupt. Duty is assessed on the gross value of the property, or portion of it, which is

transferred to the former bankrupt. For example, if a former bankrupt jointly owned a property worth $500,000 with a partner, and the property is subject to a mortgage of $490,000, the equity of the former bankrupt is $5,000. However, a transfer of the half interest by the trustee to the former bankrupt will be assessed on the gross half value of the property, that is $250,000. (Duties Act s. 27 (b) (iii). Duly on a half gross value of $250,000 is $6,935. A transfer to a bankruptcy trustee of the interest in property of a person becoming bankrupt is free of duty, as is a transfer by a bankruptcy trustee to a former bankrupt for no consideration (Duties Act s. 108). This may occur if a bankruptcy trustee forms the view that the property cannot in the foreseeable future be sold for a figure that covers the encumbrances on the property, and the costs of a sale.

5.5 A Gamble

If a debtor is considering this strategy, it is important they understand it is a gamble. If house prices are relatively stable for the duration of the bankruptcy, and the bankrupt can pay the mortgage payments reliably, then it may work. However, if house prices rise substantially through the course of the bankruptcy, the trustee is obliged to sell the property for its market value (16). The bankrupt can try to persuade family or friends to raise money to buy the equity from the trustee, or will see the property sold to a stranger despite having made mortgage payments for the duration of the bankruptcy. A newly-discharged bankrupt is likely to find borrowing difficult, so for the bankrupt to buy a sizeable equity shortly after discharge may be impracticable.

A debtor considering this strategy must also calculate the cost of the duty on the transfer from the bankruptcy trustee to the former bankrupt.

5.6 Rates, Water Rates and Insurance

If a debtor is considering keeping a house through bankruptcy in the way outlined above, it is necessary to take into account payment of rates, water rates and insurance.

Rates are a secured debt, because they are a charge on the land (17). The owner for the time being is liable (18). If rates are unpaid for three years, the local government can sell the land (19). There are similar provisions relating to water rates. They are payable by the owner or occupier of the land (20), and if they are not paid the water board can lodge a memorial on the title to the land, which prevents any dealing with the land (21). It is usual for mortgages of houses and other real estate to provide that the borrower must keep the property insured, and a failure to do this constitutes a default under the mortgage contract, which can lead to action by the lender under the mortgage.

The implication of these requirements is that a debtor must take into account in their planning payments of rates, water rates, duty and insurance if they wish to keep a property, despite being bankrupt.

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September 2017

NOTES:

1. Sistrom v Uhr 117 ALR 528
2. Official Trustee in Bankruptcy v Jordan [2004] SASC 173
3. Bagshaw v Scott (2002) 126 FCR 27
4. Bankruptcy Act s. 136

5. Bankruptcy Act s.58 (5)
6. Bankruptcy Act s. 302
7. Bankruptcy Act s. 133
8. Corporate Affairs Commission v Harvey (1979) 4 ACLR 259
9. Re Driller (1972) 21 FLR 159
10. Buttle v Saunders [1950] 2 All E.R. 193
11. Sistrom v Uhr 117 ALR 528
12. Bankruptcy Act s. 129
13. Bankruptcy Act s. 134 (1) (j)
14. Bankruptcy act s. 58 (5)
15. Bankruptcy Act s. 302
16. Buttle v Saunders [1950] 2 All E.R. 193
17. Local Government Act 1995 (WA) s. 6.43
18. Local Government Act s. 6.44
19. Local Government Act s. 6.64
20. Water Services Act 2012 (WA) s. 126
21. Water Services Act 2012 (WA) s. 128

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