

Did you know?



Alex Koodrin
National Technical Manager

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Bankruptcy and life insurance

Personal insolvency in Australia saw a slight decline from 32,865 in 2008 to 32,759 in 2011, with the latest figure consisting of 22,274 bankruptcies, 8,121 debt agreements, and 364 Part X¹ (personal insolvency) arrangements – an alternate arrangement to bankruptcy, made with creditors. Fortunately, life insurance – both inside and outside super – can help protect against this financial plight.

Individuals who are unable to pay their debts and cannot come to suitable repayment arrangements with their creditors, may voluntarily petition to become bankrupt. Creditors can also apply to make a person bankrupt if they can satisfy that the person owes them money above a minimum amount. Bankruptcy generally lasts for three years, but can be extended under certain circumstances.

Though no one is immune from bankruptcy, self-employed business people, 'at risk' professionals (doctors, dentists lawyers, accountants, architects, engineers, etc.), and company directors are particularly vulnerable to lawsuits from disgruntled patients, dissatisfied clients, or vindictive former partners. Successful litigation against these individuals may send them bankrupt, as can merely mounting a defence against a spurious claim.

Fortunately, life insurance – both inside and outside super – affords protection against bankruptcy. Under section 116(1) of the Bankruptcy Act 1966, all property that:

- belonged to, or was vested in, a bankrupt at the commencement of the bankruptcy, or
- has been acquired or is acquired by him or her, or has devolved or devolves on him or her, after the commencement of the bankruptcy and before his or her discharge

is property divisible amongst the creditors of the bankrupt. The definition of 'property' would normally include life insurance policies and their proceeds. However, the Act goes on to provide certain exemptions, as follows.

Superannuation policies

Section 116(2) of the Bankruptcy Act excludes the following (as defined by the Superannuation Industry (Supervision) Act 1993 – the 'SIS Act'): the bankrupt's interest in a regulated superannuation fund; or an approved deposit fund; or an exempt public sector superannuation scheme; or a payment to the bankrupt from such a fund received on or after the date of bankruptcy, if the payment is not a pension within the meaning of the SIS Act. It also excludes the amount of money a bankrupt holds in a Retirement Savings Account (RSA) or a payment to a bankrupt from an RSA received on or after the date of the bankruptcy, if the payment is not a pension or annuity within the meaning of the Retirement Savings Accounts Act 1997. Previous legislation exempted superannuation only up to the then existing Reasonable Benefit Limits.

However, separate provisions of the Bankruptcy Act cover contributions to the trustee of a superannuation fund both by a future bankrupt or by a third party for the benefit of a future bankrupt. Essentially, these provisions allow bankruptcy trustees to recover superannuation contributions made prior to bankruptcy with the intention to defeat creditors. These provisions apply to any 'out of character' transfers which may be outside the normal contribution patterns of members.

Based on the above, provided there was no intention to defeat creditors, insurance policies within super would not be subject to a claim by a bankrupt's creditors.

Ordinary life insurance policies

Section 116(2) of the Bankruptcy Act also exempts from section 116 (1) the following property:

¹ Insolvency statistics obtained from the Insolvency and Trustee Service Australia website, www.itsa.gov.au.

- policies of life assurance or endowment assurance in respect of the life of the bankrupt or the spouse or de facto partner of the bankrupt
- the proceeds of such policies received on or after the date of bankruptcy.

It is important to note that the exemption of life insurance (or assurance) policies is based on common law, not the Life Insurance Act 1995, definition of life insurance. Therefore, a life policy under the Life Act may not equate to a life insurance policy at common law and may not be exempt from being property divisible amongst a bankrupt's creditors under section 116(2).

A policy of life insurance includes a term life policy and, most likely, TPD or trauma policies that are riders to that policy. These policies are not property divisible amongst the creditors of a bankrupt. If the proceeds of these policies are received on or after the date of bankruptcy, the proceeds are also not divisible amongst the creditors of the bankrupt. The proceeds would go to the bankrupt policy owner, a surviving joint owner or a nominated beneficiary, or to the bankrupt policy owner's estate.

The most celebrated Australian case of life insurance and bankruptcy involved a life insurance policy, taken out in 1984 in the life of the late failed entrepreneur Christopher Skase, and his trustee in bankruptcy, Max Donnelly. Mr Donnelly held up the payment of a life insurance policy to the beneficiary, Mr Skase's wife Pixie, for months while trying to prove her late husband's creditors had a claim on the proceeds. He eventually gave up.

Standalone TPD and trauma cover and income protection cover are not life insurance at common law, and are therefore not excluded from being property divisible amongst creditors of a bankrupt. Therefore, for at risk professionals, it is worth considering having their spouses own these stand-alone policies. This strategy would not be possible for income protection policies. Any income protection policies owned by a bankrupt would normally be subject to a legislated income contributions amount which is periodically indexed.

Case study

Trevor is an undischarged bankrupt, has an income protection policy and is on claim. His monthly benefit is \$6,000, he has no other income and no dependants. Trevor is entitled to receive income up to a current (as of 27 October 2011) threshold of \$47,265.40 per annum, above which he must pay 50c of every \$1 to the bankruptcy trustee. This means that after paying tax on his income and the Medicare Levy, his income contribution would be \$4,252.30 or \$163.55 per fortnight. Trevor's requirement to make income contributions would apply equally to a superannuation pension.

The question arises: If Trevor held his income protection through a super fund, would it be excluded from access by creditors? The answer hinges on whether the payment by the super fund of temporary incapacity constitutes a pension under SIS or under common law. Whilst it is highly unlikely that the payment would be a pension under SIS, it is very strongly arguable that any regular payment from a superannuation fund is a pension at common law, and therefore accessible by creditors.

It would therefore seem prudent for undischarged bankrupts not to begin superannuation pensions, but rather to make lump sum withdrawals as required to use for living and other expenses.

Summary

Life insurance policies – both inside and outside superannuation – and their proceeds afford protection for bankrupts against claims by creditors. Bankruptcy protection is yet another reason why life insurance is an appropriate wealth protection vehicle.

Did you know...? The word bankruptcy actually comes from Italian *banca rotta*, a broken bench (not a rotten one - it's from Latin *rumpere*, to break). The bench was a literal one, however: it was the usual Italian word for a money dealer's table (and indeed is the origin of our *bank* for a financial institution and also for the sense of *break* in phrases like "He's gone broke").

Important information

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