DID YOU KNOW?

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Bankruptcy and life insurance

The number of total personal insolvencies in Australia increased 4.4% in 2015-16 compared to 2014-15. By type of personal insolvency: bankruptcies increased 0.2%; debt agreements increased 11.4%; and personal solvency agreements fell 18.2%. The rise in bankruptcies in 2015-16 is the first annual rise since 2008-09.

So what is the treatment of life insurance proceeds, outside and inside super, in the event of bankruptcy?

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 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 – may be protected 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 property (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 provided 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 provided the payment is not a pension or annuity within the meaning of the Retirement Savings Accounts Act 1997.

However, separate provisions of the Bankruptcy Act cover contributions to the trustee of a superannuation fund both by a future bankrupt (section 128B) or by a third party (section 128C) for the benefit of a future bankrupt. 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:

- 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 the common law definition of life insurance expressed by the High Court in National Mutual Life Association of Australasia Ltd v Federal Commissioner of Taxation (1959), not the Life Insurance Act 1995. There is a longstanding discrepancy between the Bankruptcy and Life Insurance Acts as to what constitutes a policy of life insurance. Thus, 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 following various stamp duty cases, most likely, total and permanent disability (TPD) or trauma policies that are a rider to the term life policy. These riders are unlikely to be considered 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.

Until recently, standalone TPD and trauma cover and income protection cover have not been considered life insurance at common law, and therefore not excluded from being property divisible amongst creditors of a bankrupt. Any income protection policies owned by a bankrupt would have been subject to a legislated 'income contributions' amount which is periodically indexed, currently $54,736.50 net of tax (as of 25 January 2017) for a bankrupt with no dependants. The Trustee in Bankruptcy is entitled to 50c of every $1 above this threshold.

Berryman v Zurich Australia Ltd [2016] WASC 196

This recent decision by the Supreme Court of Western Australia held that a bankrupt's entitlement to claim a TPD benefit under a life insurance policy is not an entitlement that is divisible among the bankrupt's creditors and therefore does not vest in the Official Trustee in Bankruptcy.

Mr Berryman was a self-employed carpenter who suffered an accident at work on 7 July 2009, when a large granite rock crushed his foot. On 16 November 2009 he made a claim under his Protection Plus policy with Zurich, which commenced on 17 June 2009, for the payment of a TPD benefit of $2 million, which was subsequently declined. On 29 August 2014 Mr Berryman commenced an action for damages against Zurich for breach of contract in the sum of $2 million. He was declared bankrupt on 31 August 2015.

The judge, Justice Tottle, held that the TPD claim fell within sections 60(4) and 116(2)(g) of the Bankruptcy Act. Section 60(4) preserves the right of a bankrupt to continue with an action in respect of the rights specified in section 116(2)(g), It states: 'Notwithstanding anything contained in this section, a bankrupt may continue in his or her own name, an action commenced by him or her before he or she became a bankrupt in respect of:
(a) any personal injury or wrong done to the bankrupt, his or her spouse or de facto partner or a member of his or her family; or (b) the death of his or her spouse or de facto partner or of a member of his or her family.'

Section 116(2)(g), on the other hand, excludes from property divisible amongst the creditors of a bankrupt 'any right of the bankrupt to recover damages or compensation for personal injury or wrong done to the bankrupt…'

His Honour considered that with respect to the law of bankruptcy, the TPD claim should be characterised as a claim for compensation for a personal injury or wrong which was not part of the legitimate entitlements of creditors. It will be interesting to see if this issue is elevated to an appellate court where section 116(2)(g) is considered.

Though only a decision of a single judge, the decision appears clear authority for the proposition that a right to sue for a TPD – and by extension – an income protection or trauma policy benefit, does not become vested in the trustee if an insured becomes bankrupt.

Summary

Depending on the circumstances, life insurance policies – both inside and outside superannuation – and their proceeds may afford protection for bankrupts against claims by creditors. Bankruptcy protection is another important factor when considering life insurance as an appropriate wealth protection vehicle.

Important information

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