AFFIRMATIVE
BUSINESS ADVISORY

BANKRUPTCY & PERSONAL INSOLVENCY

Bankruptcy is a legal process where a bankruptcy trustee is appointed to administer an insolvent person's affairs, in order to provide for a fair distribution of that person's divisible assets to their creditors.

Why choose bankruptcy?

The Bankruptcy Act 1966 exists to protect debtors (i.e. the bankrupt) and creditors.
The debtor is protected from being pursued by creditors and, with limited exceptions, is released from their debts upon their discharge from bankruptcy. Bankruptcy aims to provides a debtor with a fresh start. Bankruptcy protects creditors' interests by having an independent, qualified professional control and investigate the bankrupt's affairs and collect and distribute the bankrupt's divisible assets.

Bankruptcy and the home

How the Bankruptcy Act 1966 applies to a bankrupt's home is often misunderstood. A number of factors apply as to whether it will be sold in a bankruptcy appointment.
Understandably, if a bankrupt loses their home, when applicable it also will disrupt the family unit, any dependants, and partners/spouses. Bankruptcy trustees must approach a realisation of a bankrupt's interest in their home with tact and understanding, while protecting creditors' rights and interests.

Is the home protected?

No. A home is not a protected asset under the Bankruptcy Act. If there is equity in the property after paying out any proper mortgage and selling costs, the trustee is obliged to realise the property.

What about joint ownership?

The realisation process is relatively straightforward when the bankrupt is the only owner of the home, or all owners are bankrupt. However, often the bankrupt and their non-bankrupt partner/spouse will own the home as 'joint tenants'. When the bankrupt and a non-bankrupt co-owner jointly own the home, the trustee can still insist on realising the bankrupt's share of the equity.

What happens to joint tenancies on the bankruptcy of one or more owners?

A joint tenancy is automatically severed upon the bankruptcy of any one of the joint tenants–at least as far as it relates to the bankrupt's ownership interest.
This occurs due to the 'involuntary alienation'–or severing of the owner's fundamental legal rights–that is necessary to create a joint tenancy. This practice is long-established with reference to the 1862 case of Paten v Cribb.

The trigger to this alienation of legal rights is the property vesting in the trustee, which occurs when the bankruptcy commences.

After the joint tenancy is severed, those interests in the property are held as ‘tenants in common’. This is important if a bankrupt dies during the bankruptcy. If the joint tenancy had not been severed, the bankrupt’s share of the property–and the equity attached to that share–would automatically vest in the co-owner upon the bankrupt’s death, and the estate would lose the equity in the property.

How is the equity in a property determined?

The trustee will get the property valued to determine the equity. Secured debts (e.g. mortgages, etc.) are deducted from the property’s value and the bankrupt’s share of the equity is calculated.

What if there is no equity in the property?

When there is no equity in a property and the debts secured against the property are greater than the current property value, the mortgagees may exercise their rights and sell the property.

If mortgagees don’t exercise their rights, the bankrupt–and possibly other parties–can continue to service the loan. The property vests in the trustee at the time of bankruptcy and remains vested regardless of whether the trustee takes action to sell the property, or when there is no equity in the property. The property remains vested in the trustee when the bankrupt has been discharged from bankruptcy.

The bankruptcy trustee may review the property’s equity position periodically. They can realise any equity generated after the date of bankruptcy, even if the equity has been generated by the continued mortgage repayments by the bankrupt or another owner. Mortgage repayments attributed to the bankrupt’s share are deemed to be rental payments to use and occupy the property.

How are properties realised?

Where the trustee is the only owner, they can put the property up for sale. Where there is a co-owner, the trustee will usually take the following approach:

1. Give the co-owner the opportunity to buy the estate’s interest in the property.
2. Invite the co-owner to join the trustee on agreed terms to market and sell the property.
3. If there is no agreement to sell the property, the trustee can ask the court to appoint a ‘statutory trustee for sale’ over the co-owner’s interest to force a sale of the property.

The appointment of a statutory trustee forces the sale of the home, even if the co-owner is solvent and has not contributed to the bankruptcy in any way. While the court will often try to soften the effect of such an order by allowing the co-owner time to relocate, the outcome is that the property will be sold.

What is entering transmission?

‘Entering transmission’ is the legal process to have the trustee’s name placed on the certificate of title in place of the bankrupt’s name. This is necessary for the trustee to execute a sale contract and transfer forms when selling the property.

Usually the trustee will only enter transmission if satisfied that there is equity in the property. In the interim, the trustee can lodge a caveat over the title to protect the estate’s interests for the short-term, giving the trustee time to determine what to do with the property.

What about mortgagees?

The majority of homes are subject to a mortgage. The mortgage may be enforced during the bankruptcy, even when the mortgage payments are up-to-date, as the bankruptcy itself may constitute a default in the terms of the mortgage. Although mortgagees have the right to sell the bankrupt’s home, in most cases they will leave this task to the trustee.

What if the bankrupt can continue with mortgage repayments?

If the bankrupt has the capacity to continue making mortgage repayments, usually the mortgagee will not insist upon possession of the property–preferring that the loan repayments continue. The trustee and bankrupt may negotiate payment for any equity in the property to the estate.

This type of arrangement benefits everyone concerned: the bankrupt's creditors benefit from the property's equity in the estate; the mortgagee retains a performing loan; and the bankrupt avoids losing their home.

However, the trustee can sell the property at any time, even if the mortgage repayments are up-to-date. This means that the estate will benefit from the extra equity generated in the property from additional repayments.

What about getting vacant possession?

Normally, the trustee will need to provide vacant possession when selling a property. A trustee would not usually expect a bankrupt to vacate the property immediately upon bankruptcy; in normal circumstances a few weeks would be allowed for alternative arrangements to be made.

In some cases, the trustee may allow the bankrupt to stay in residence during the selling period provided the bankrupt assists in that process, pays a fair rent, maintains the property, and provided the trustee is satisfied of the bankrupt's continued cooperation in the bankruptcy process.

How are the proceeds of sale distributed?

If the property is wholly owned by the bankrupt, the estate will receive the entire surplus of the sale after any mortgagee and selling costs are paid. If the property is co-owned, the trustee will share the surplus with the co-owner (non-bankrupt) as per the legal entitlement on the title deed.

Although the title to a property may be held equally, situations arise where unequal contributions have been made towards acquiring or developing the property. This may lead to one party holding the property for the other party in a constructive or resultant trust, and will potentially alter the sale distribution. The sharing of equity may also be altered under the 'doctrine of exoneration' if one owner on title uses loans secured on the property, and not the other.

When does the doctrine of exoneration apply?

The property may be encumbered by a mortgage that secures a loan for the sole benefit of one owner, even though all owners have agreed to the mortgage. The doctrine of exoneration says that the person who received the benefit of the loan should have the first obligation to repay the loan–and the co-owner should only be considered a surety (guarantor) and their share should only be used to meet any shortfall.

A simple example of the doctrine is a home worth $400,000 owned by the bankrupt and a non-bankrupt partner/spouse. Prior to bankruptcy they agreed with the bank taking a mortgage over their property to support an advance of $150,000 to the bankrupt's business. Upon sale of the property, $250,000 would be available for distribution to the owners (i.e. $400,000 sale price less the $150,000 mortgage). Because each owner had an equal share in the legal title to the property it might be thought that they should each receive $125,000. However, the doctrine of exoneration can require that the amount due under the mortgage should be deducted from the bankrupt's equity so that the following equitable distribution would apply:

Bankrupt's share = $200,000
less $150,000 = $50,000
Spouse's share = $200,000

The trustee must find compelling evidence that the doctrine of exoneration should apply.

Is there a timeframe for the sale of the property?

Section 129AA of the Bankruptcy Act requires trustees to realise property within a period ending six years after the discharge of a bankrupt. This allows nine years to arrange these sales. If the trustee does not sell within the timeframe, the property could potentially revest in the discharged bankrupt.

The six-year rule only applies to property disclosed to the trustee. If the property is not disclosed in the bankrupt's Statement of Affairs or as after-acquired property, the trustee will have 20 years to deal with the property.

War service homes

A bankrupt or a debtor under Part X of the Bankruptcy Act cannot have a war service home taken from them under the Defence Service Homes Act 1918, except in extraordinary circumstances. Although the department has the discretion to allow a trustee to sell the bankrupt's property, in reality this discretion is rarely applied. In our experience, the secretary will not exercise their discretion even when the bankrupt has incurred very substantial business debts.

Undoubtedly, some bankrupts take business risks—which they would otherwise have avoided—in the knowledge that they cannot lose their war service home. This is inequitable as far as creditors are concerned, but it is currently the law.

Summary

A bankrupt's home can be sold even if the bankrupt only has a part interest in the property.

1. The trustee will normally offer the property for sale to any co-owner prior to having the property placed on the market.
2. The trustee will normally sell the interest in the property without undue delay.
3. The trustee must recover the value for the property, but has a wide discretion regarding how to sell.
4. The trustee will normally allow the bankrupt a few weeks to arrange alternative accommodation.
5. The doctrine of exoneration, may adjust the distribution of the sale proceeds.
6. War service homes are excluded from realisation.

Disclaimer

This document provides general information only and does not constitute legal or financial advice. For advice tailored to your circumstances, please consult a qualified professional.