Superannuation, bankruptcy and staying out of court

- by Matthew Burgess, Director, View Legal

As reported at 2017 WTB 37 [1302], the Federal Court's decision in *Cunningham (Trustee) v Gapes (Bankrupt)* [2017] FCA 787 (Federal Court, Collier J, 13 July 2017) (**Cunningham**) is vital guidance for all advisers in relation to the interplay between superannuation death benefits and the *Bankruptcy Act 1966*.

In particular, ***the case highlights the fact that a superannuation death benefit paid via a deceased estate to a bankrupt beneficiary is divisible amongst the creditors of the bankrupt***.

As also mentioned at 2017 WTB 37 [1302], at a minimum, advisers should consider advising clients who have at risk potential beneficiaries to utilise a binding death benefit nomination (**BDBN**). The BDBN should mandate that any death benefit is paid directly from the superannuation fund to a beneficiary at risk of bankruptcy.

The article by Matthew McKee of Brown Wright Stein Lawyers (see 2016 WTB 38 [1253]) provides an excellent overview of the key issues in relation to superannuation and bankruptcy, and 1 of the leading decisions in this area, namely the case of *Trustees of the Property of Morris (Bankrupt) v Morris (Bankrupt)* [2016] FCA 846.

Testamentary trusts

One additional strategy that should be considered in the context of deceased estates generally, and specifically in relation to superannuation death benefits, is ***the use of comprehensive testamentary trusts***.

As readers will be aware, 1 of the key reasons that testamentary trusts are often recommended is due to the asset protection offered by the structure generally, and in particular where a potential beneficiary is at risk of suffering an event of bankruptcy.

This approach can help protect beneficiaries, regardless of whether a BDBN is in place, or where a BDBN is implemented and mandates payment of the death benefits to the legal personal representative for distribution under the will.

Importantly, testamentary trusts also provide significant flexibility from a tax planning perspective, as compared to the benefits being paid directly to the bankrupt beneficiary. Previous articles have explored a number of the tax planning issues in relation to testamentary trusts (see for example our articles reported at 2014 WTB 19 [658], 2014 WTB 21 [754] and 2015 WTB 40 [1475]).

Unfortunately, we have seen a number of examples recently where no testamentary trust has been incorporated under a will, with superannuation death benefits passing directly to the estate and then in turn to a bankrupt beneficiary. In other words, creating the exact same factual matrix as existed in *Cunningham*.

Key issues to remember

In summary, the key issues to be aware of in this type of situation are as follows:

- Where a beneficiary is bankrupt at the time of the death of the willmaker, the bankruptcy legislation mandates that the bankrupt's entitlements are to pass to their trustee in bankruptcy.
- If there are any assets remaining after the bankruptcy has been discharged, then the beneficiary is entitled to those assets.
- The right to due and proper administration of the deceased estate is an asset that forms part of the bankrupt's estate, and therefore also vests in the trustee in bankruptcy.
- If an executor of an estate seeks to avoid assets passing to a trustee in bankruptcy where a beneficiary is entitled personally under the will, the executor will themselves be personally liable.

Importantly, each of the above issues can be legitimately avoided by the appropriate structuring of a testamentary trust into a will, prior to death.

Where testamentary trusts are not included under a will, best practice dictates that the executor should obtain a formal declaration from each beneficiary, before making distributions to them under the will, whereby each beneficiary confirms that they are in fact solvent.

If a beneficiary refuses to provide the declaration, then further searches should be made by the executor to minimise the prospect that the executor might become personally liable to a trustee in bankruptcy.

A case study example

One example of a factual scenario we have been recently asked to assist with that highlights the importance of advisers working collaboratively in this area to deliver value to clients is as follows:

- An accountant had provided a written recommendation to a willmaker that testamentary trusts should be included in their will for asset protection purposes - this advice included a specific recommendation in relation to 1 beneficiary who had a history of financial misadventure in business activities.
- The advice was provided to the willmaker's long-standing, although unspecialised, lawyer who dismissed the recommendation for testamentary trusts on the basis that it was an 'unnecessary complication that accountants and financial planners push as part of their product sales'.
- At the time of the willmaker's death, the relevant son was indeed bankrupt.
- In working to discharge their duties, the executors of the will asked us to assist in obtaining probate of the will and also confirm that they were obliged to pay the bankrupt beneficiary's entitlements to the trustee in bankruptcy. We were able to obtain probate and also confirm the duty that the executor was obligated to pay to the trustee in bankruptcy.
- The executors also sought advice from specialist litigation lawyers as to whether the accountant or the lawyer could be potentially liable for failing to ensure that the willmaker included a testamentary trust in their will.
- The specialist litigation advice suggested that the prospects of recovering any damages were in fact quite low for the bankrupt beneficiary.
- The primary reason for this was that if a testamentary trust had been used, then the bankrupt beneficiary would have simply been 1 of many potential beneficiaries, and the only 'asset' that they would have received would have been the right to due administration of the testamentary trust. This right to due administration would

arguably have no monetary value and therefore the damages awarded on suing the lawyer and accountant would have probably only been nominal.

The above conclusion was not ultimately tested through the court system. It would therefore seem an unnecessarily risky approach for advisers to dismiss the benefits of testamentary trusts for bankrupt beneficiaries on the basis that they may not be liable if their advice is later shown to be inappropriate.

Conclusion

The need to take active steps to protect assets and wealth, as well as concerns with the overall effectiveness of the steps taken, are not new concerns.

Arguably however, those concerns have never been taken more seriously by a greater number of people than they are currently, particularly in relation to superannuation death benefits.

The recent case law in this area is a timely reminder of the need to ensure comprehensive asset protection strategies are implemented as part of an integrated tax and estate planning exercise.