Divisible property in bankruptcy - clarification of personal injury exclusion

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Summary

The notion of 'divisible property' in bankruptcy is broadly framed but it has some exclusions. A right by a bankrupt to the recovery of damages or compensation for personal injury is one such exclusion. Simply because a personal injury enlivens a right to a claim for a specific amount under an insurance policy, does not materially change the character of that right: it is a right to recover damages or compensation in respect of a personal injury. Accordingly, such a claim under a policy of insurance is excluded from the scope of divisible property.

Background

The plaintiff was a self-employed carpenter who took out a policy of insurance which would provide the payment of a benefit in the event of his total and permanent disability (TPD). The plaintiff suffered personal injury as a result of an accident while at work. He made a claim on the insurer for payment of the TPD benefit. The claim was declined and thereafter, the plaintiff commenced proceedings against the insurer. Subsequently, the plaintiff became bankrupt.

The court was obliged to determine the threshold issue: was the claim under the TPD policy one that could only be pursued by the plaintiff's trustee in bankruptcy or was the right to bring this claim 'carved out' from the divisible property of the plaintiff's bankrupt estate?

Decision

Statutory framework

Relevantly, section 5 of the *Bankruptcy Act 1966* (Cwth)[1] provides that 'property' means:

> any real or personal property of every description … and includes any estate, interest or profit, whether present or future, vested or contingent, arising out of or incident to any such real or personal property.

Section 5 also defines the phrase 'the property of the bankrupt' to include the property divisible among the bankrupt's creditors and any rights and powers in relation to that property that would have been exercisable by the bankrupt if he or she had not become bankrupt.

Property that is divisible among the creditors of the bankrupt includes all property that belonged to the

bankrupt at the commencement of the bankruptcy[2], as well as the capacity to bring proceedings for exercising all powers over such property[3].

Certain categories of property are, however, not divisible among creditors of a bankrupt. For example:

- policies of life insurance in respect of the life of the bankrupt are excluded[4]; and
- critically, for the purposes of this case, section 116(2)(g) excludes from the notion of property divisible among a bankrupt's creditors any right of the bankrupt to recover damages or compensation **for personal injury** done to the bankrupt and any damages or compensation recovered by the bankrupt (whether before or after he or she became a bankrupt) **in respect of such an injury.**

Pursuant to section 60(4) if, before bankruptcy, a bankrupt had commenced an action in respect of personal injury to the bankrupt then he or she could continue the action in his or her own name.

Characterising the right

It was contended on behalf of the insurer that the right of the plaintiff had to sue for the alleged breach of the policy of insurance was a chose in action, that is, a proprietary right, which was property for the purpose of section 5. It was therefore property which vested in the trustee in bankruptcy unless it was somehow excluded from property divisible amongst the plaintiff's creditors by section 116(2). It was further put that the policy was not a 'policy of life assurance' (thus negating the effect of section 116(2)(d)(i)) and nor was it a claim for personal injury (which would otherwise engage section 116(2)(g)): it was a claim for a defined sum under a policy of insurance arising on the occurrence of an agreed contingency and did not involve an assessment of damages by reference to the extent of the bankrupt's injury or the pain suffered by him as a result of that injury. Accordingly, the bankrupt had no capacity to maintain these proceedings.

The focus of the judgment was not on the nature of the policy but rather, whether it could be said that the claim was in respect of a right of the bankrupt to recover damages for personal injury.

Drawing on earlier decisions[5], the judge noted that the common thread running through similar cases was that 'where the primary and substantial right of action is direct pecuniary loss to the property or estate of the bankrupt, the right to sue passes to the trustee, notwithstanding that it may have produced personal inconvenience to the bankrupt'[6]. For example, claims for damages for loss of credit, mental distress and injury to a person's mental health were not claims without reference to that person's rights of property; rather, such claims were consequential upon losses to that person's property and financial interests as a result of breaches of professional duty owed by the bankrupt's solicitors. They thus constituted causes of action which formed part of the bankrupt's property and which vested in the trustee in bankruptcy.[7]

The essential rules in determining the character of a claim such as in this case are as follows[8]:

- If proceedings arise out of property of the bankrupt that has passed to the trustee, the bankrupt will have no interest in or entitlement to that property and the cause of action will have vested in the trustee.
- Where the primary and substantial right of action is direct pecuniary loss to the property or estate of the bankrupt, notwithstanding that it may have produced incidental personal inconvenience to the bankrupt, it will vest in the trustee.
- Where damage to reputation or a personal claim extends beyond incidental personal inconvenience to the bankrupt but would not in and of itself form the basis of a separate cause of action, the bankrupt has no standing in respect of a claim arising out of property that has passed to the trustee.
- When the essential nature of the wrong is personal, the cause of action remains with the bankrupt.
- The essential nature of the wrong is personal where the damages or part of them are to be assessed by reference to the loss sustained by the bankrupt in respect of his or her mind, body or character and without reference to his or her rights of property.

Sections 60(4) and 116(2)(g) are complementary of one another. The phrase 'in respect of' in section 60(4), the word 'for' in section 116(2)(g)(i) and the phrase 'in respect

of' when used in section 116(2)(g)(ii) are to be given the same meaning. To do so is to give effect to the purposive approach to statutory construction which requires sections to be construed so that they may operate harmoniously.

True it is that the plaintiff was suing to enforce a contractual right, but that of itself did not compel the conclusion that the action was outside the scope of the section 60(4) exception. That section and 116(2)(g) focus on the substance of the claim, not the form of the action.

Assume a bankrupt were to bring a claim for a breach of an agreement to settle a claim for personal injuries. The original claim was plainly a claim for damages for personal injury. The interposition of the contractual claim (because of the unexecuted settlement) does not change the character or substance of the injury for which compensation is payable. It remains a claim for compensation in respect of personal injury suffered by the bankrupt. Similarly, the fact that the quantum has been fixed by agreement does not change the character or substance of the action. The rights under a policy of disability insurance are only valuable if the insured suffers an injury of the nature specified in the policy. The value is entirely dependent on the insured suffering a personal injury of sufficient seriousness to satisfy the policy conditions. The substance and nature of the plaintiff's claim are not altered by the interposition of the policy between the injury and the proceedings.

The fact that the amount of compensation under the policy is fixed does not detract from the proposition that immediate reference must be made to the nature of the bankrupt's injuries and their consequences in order to determine whether he or she is entitled to the TPD benefit[9].

Implications

There is an increasing take up of TPD policies with the inevitable consequence that an increasing number of people who become bankrupt will be entitled to claims under such policies. *Berryman* is the first case which has been decided precisely concerning the issue of how to characterise a claim under a TPD policy in the context of bankruptcy.

Merely because the claim is not one for damages at large taken against some party who may have caused personal injury (indeed, in this case, there was no reference to any such third party) or the fact that the claim may be for a specific sum arising because of the occurrence of a particular event (a personal injury) covered by a policy of insurance, will not mean that the entitlement to bring the claim and any payment made pursuant to the claim will constitute divisible property for the benefit of the bankrupt's creditors.

[1] All statutory references in this paper are to this Act
[2] Section 116(1)(a)
[3] Section 116(1)(b)
[4] Section 116(2)(d)(i)
[5] *Cox v Journeaux (No 2)* [1935] HCA 48 and *Faulkner v Bluett* [1981] FCA3
[6] *Faulkner v Bluett* at [119]
[7] *Mannigel v Hewlett Phelps* (unreported, NSWCA, 12 June 1991)
[8] *Sheehan v Brett-Young (No 2)* [2016] VSC 39
[9] *Berryman* at [69]

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