Our submission to Treasury on a Legislative Framework for Insolvent Trading Trusts

Question 1 - *Should the corporate insolvency framework be amended so that it expressly provides for the external administration of insolvent trusts with a corporate trustee? If so, what external and adminisatration processes should the amendments apply to?*

Yes, the corporate insolvency framework should be amended so that it expressly provides for the external administration of insolvent trusts with a corporate trustee.

There has been recognition for at least forty years that with trading trusts '[t]he scope for frustrating creditors is considerable'.[1] It has been well-known for this entire period that on liquidation a creditor may 'discover for the first time that the company with which [they] dealt was in fact a trustee and that [they] have no rights against any assets at all'[2] and that '[d]ifficult questions could arise as to the different classes of creditors inter se, where the company in liquidation had both 'personal' creditors and trust creditors, and 'personal' assets and trust assets.[3] Risks to creditors from trust deeds permitting removal of insolvent corporate trustees and preventing the exercise of the trustee's right of indemnity have also been acknowledged during these past forty years.[4]

The absence of any express reference to the statutory regime applicable to the external administration of insolvent trusts leads to ambiguity and confusion. External administrators are regularly advised to make applications to the Court for directions lest their actions expose them to liability by a disaffected stakeholder.

The amendments must apply to all the external and administration processes. If not the uncertainty and confusion about how the legislative provisions apply in the context of a trading trust situation will continue.

The areas for amendment include:

1) The liquidator's role, powers and duties;
2) Assets available to creditors;
3) Priorities;
4) Clauses in trust deeds that remove insolvent trustees or limit the trustee's right of indemnity.

Whilst we note that the reform is intended to apply to the corporate insolvency regime the same issues affect personal insolvency and so the amendments should apply equally to personal insolvencies as well (by amendment to the *Bankruptcy Act 1966* (Cth)).

Question 2 - *What benefits would a legislative framework deliver?*

There are numerous benefits that a legislative framework would deliver including:

- Clarity for all stakeholders (directors, shareholders, trade creditors, employees, secured creditors i.e. banks, insurers, advisors, insolvency practitioners, revenue collectors), as to how the insolvency regime will apply to the insolvency of the trust.
- More certain outcomes that can be factored in to decision-making in the establishment of the corporate trust vehicle and the options available when insolvency is near.
- Reduced costs of lending – because more certainty can reduce costs, and also reduce waste by reason of unnecessary court applications or disputes.
- Reduced premiums in trade credit insurance policies.
- Reduced costs for insolvency administrations involving a corporate trading trust because the processes will be clearer, and there will likely be reduced need to seek legal advice, apply to the court for directions, or appoint a receiver to the trust assets.

Question 3 - *Is there potential for detrimental or unforeseen impacts if the statutory regime is extended?*

Yes there is potential for detrimental or unforeseen impacts if the statutory regime is extended.

One risk is that an extended statutory regime may catch trusts that are not intended to be treated as 'trading trusts'. This is because there is a fundamental definitional issue about what a trading trust actually is. It appears that what is contemplated is a corporate trustee which in its trustee capacity carries on business.[5] However this overlooks that these trusts may take a variety of structures and the term 'trading trust' may have a wider or narrower meaning.[6]

Further the terms of the trust or statute[7] may grant a trustee the power to carry on business. This often arises with testamentary trusts. [8] However this power may also arise with *inter vivos* discretionary and family trusts and also self-managed super funds. Indeed the observation that a trading trust 'is an example of the family trust gone commercial' [9] hints at the potential range of trusts that a statutory regime may unintentionally affect.

There are also potential detrimental impacts for beneficiaries of trusts. One foreseeable difficulty is an approach that treats beneficiaries of a trust like shareholders of a company. That is problematic because companies and trusts traditionally serve different purposes at general law. Trusts for instance were developed under equitable principles which treat the trust assets as 'owned' by the beneficiaries with the result that trust law emphasises 'the protection of the beneficiaries and "their" assets'. [10] In contrast the corporation has always facilitated enterprise and risk-taking by its shareholders through limited liability.[11]

We can envisage situations where a corporate trading trust is the trustee of multiple trusts and owes duties to the beneficiaries of each of those trusts to act in their best interests and must subordinate personal interests to the interests of the various beneficiaries. There are other equitable duties that apply as well. While the duties can be carried out when the trustee and the trust is solvent, they become virtually impossible to uphold in the context of insolvency where conflict between duties are commonplace.

The extension of the statutory regime must take into account these equitable obligations and find a solution to this delicate situation involving multiple fiduciary obligations.

Another detrimental impact may arise for beneficiaries if the statutory regime stops them from excluding their usual liability to indemnify the trustee.[12] While there is an argument that a beneficiary should provide recompense if the trading trust becomes insolvent, the Harmer Report recommended against such a regime noting that many beneficiaries 'have little if any influence over a trustee and thus should not be held responsible for the trustee's trading activities'.[13]

Finally, while a statutory regime may provide robust or consistent laws, it is always possible that some involved may seek to exploit loopholes in laws and structure their arrangements so that they fall outside an extended statutory regime.

Question 4 - *Should legislation expressly set out when a trust is deemed to be insolvent?*

Yes, legislation should expressly set out when a trust is deemed to be insolvent.

The law is very uncertain on this point because Courts have not laid down any consistent principles about when a trust is insolvent.

To put this into context one Court has observed that 'there is a dearth of authority on the 'winding up' of an insolvent trust'.[14] Immediate obstacles are that there is doubt about whether a Court can direct a winding up akin to the winding up of a company under the Corporations Act[15] and also that the modern law to wind up an insolvent trust remains largely unaffected by statute.[16] D'Angelo[17] points out that the definition of 'insolvency' in s 95A of the Corporations Act refers to whether a 'person' is able to pay their debts. As a trust is not a 'person', it is not possible for a trust to become 'insolvent' in the sense contemplated by the Corporations Act.[18]

D'Angelo though refers to case law examples involving wind ups of managed investment schemes on the basis it is 'just and equitable'.[19] Managed investment schemes are a form of trusts and are also not a 'person' and the Corporations Act 'insolvent' definition does not apply to them.

These case law examples cited by D'Angelo reveal that in the managed investment scheme context 'insolvency' means something different from the Corporations Act definition.[20] Further, these cases did not adopt a consistent approach or develop a consistent 'insolvency' definition for trusts or managed investment schemes.[21]

Another consideration is that scenarios arise where the trustee is solvent but the trust is not financially viable.[22] This ultimately may have consequences for the trustee's solvency if the trustee has not limited personal liability for trust debts.[23] However in the absence of a statutory definition it is unclear as to when and how an insolvent trust issue crystallises for the trustee.

Question 5 - *What is the most appropriate way to describe when a trust is taken to be insolvent?*

The definition in s 95A of the Corporations Act provides a suitable starting point for describing when a trust is taken to be insolvent.

However, the need to apply company law, trust law and contract law principles to the question of determining

when a trust fund is insolvent means that a working definition for the insolvency of a trust will be more complicated.

We draw to Treasury's attention D'Angelo's observations of cases referring to the 'financial viability' of a fund and the ability of the trustee to pay trust debts and seek exoneration out of trust assets.[24] D'Angelo suggests that the ultimate question is whether and how the financial state of the fund affects the ability of the trustee to pay all its trust debts when due and payable.[25] We agree with his analysis.

Question 6 - *Should the power of an insolvency practitioner to administer the trust assets and liabilities be expressly provided for in legislation?*

Yes.

Generally, insolvency practitioners should be able to administer trust assets and liabilities without the need to apply to the Court for their appointment as receiver of trust assets. For maximum clarity and protection of the relevant insolvency practitioner (who performs a fiduciary role) this power should be expressly provided for by legislation.

We agree with the recommendation in the Harmer Report that:[26]

> ...there should be a legislative provision stating that a reference to the business or affairs of a company for the purpose of the operation of the insolvency provisions of the legislation should expressly include a reference to its business or affairs as trustee.

The consequence of adopting that recommendation is that the liquidator may control the assets and liabilities attributable to the trust. In that sense the liquidator does not administer the affairs separately but instead administers the affairs of the company and the trust together.

If adopted it reduces administrative time and cost, enables control of the trust fund out of which the trust creditors are paid, and promotes consistency in approach.[27] It removes contrary suggestions that property held by the company on trust does not come under the liquidator's control.[28] It also reflects the commercial reality that with the vast majority of trading trusts the company's 'affairs' are also the trust's affairs.

We also agree with the recommendation in the Harmer Report that:[29]

> Any reference in the companies legislation to the property or assets of a company that is being wound up in insolvency should include property and assets held by the company as trustee to the extent that the company is entitled to a charge or other beneficial interest in respect of the property or assets.

The Harmer Report made that recommendation because there were doubts over the liquidator's powers to deal with trust assets. That is the liquidator could only deal with assets in the company's own right and could not deal with trust assets beneficially held for others.[30] The Harmer Report saw this recommendation then as:[31]

> ...ancillary to the provision relating to the 'business and affairs' of the company and reflect[ing] the intention that the collection, realisation and distribution of 'trust' property should be within the power of the liquidator.

We note though that issues can arise where a company is trustee of multiple trusts, some of which may remain viable despite the insolvency of the trustee or another trust. This can adversely affect the rights of beneficiaries of viable trusts. We would therefore submit that provision should be made within the legislation to deal with situations where a company is the trustee of multiple trusts. For example, insolvency practitioners should be given better information gathering powers to determine whether any further trusts over which the insolvent trustee has also been appointed are also insolvent. This would enable the insolvency practitioner to easily apply to the Court to seek appointment over any additional insolvent trusts if they have a reasonable suspicion of insolvency along with appropriate evidence to support their application.

Question 7 - *Should the law provide that, subject to a contrary order by a court, the same insolvency practitioner may administer both the company, and the assets and liabilities attributable to any trusts for which the company is trustee?*

Generally, the law should provide that the same insolvency practitioner may administer both the company and the trust's assets and liabilities. There are good reasons why that should be permitted which are set out in our answer to question 6 above.

Guidelines for practitioners as to the management of conflicts which can arise should be prepared by industry bodies, with creditors (or the liquidator itself) provided standing to make a court application to have a separate person appointed to the trust assets if there is good reason for it. Additional obligations should also be imposed on liquidators to identify what is or isn't trust property so that creditors can be confident that the trust's activities have been properly scrutinised by the insolvency practitioner.

Question 8 - *Should the affairs of a trustee company and each trust it administers be resolved separately in external administration?*

Yes the affairs of a trustee company and each trust it administers should be resolved separately in external administration. This involves separately resolving the

assets and liabilities attributable to each trust from the assets and liabilities of the trustee company. This is consistent with the recommendation in the Harmer Report that the company and trust property be kept separate.[32]

While we find that the corporate trustee usually carries out business in just their trustee capacity we also see examples in practice of companies performing dual roles. Some companies carry on business on behalf of more than one trust.[33] In addition we often encounter companies who ostensibly contract in just their own right but in fact intend to contract in their trustee capacity.[34]

Consequently situations arise where there are multiple groups of creditors. Some of these creditors may have claims against trust assets. Others may only have claims against the company's assets only.

The Harmer Report observed that equitable principles require that company and trust property and the respective sets of creditors must be kept separate.[35] A majority of the High Court of Australia has endorsed this approach in the *Amerind* decision.[36]

Further, treating the company and trust property separately better caters for the differing positions between the shareholders of the company and the beneficiaries of the trust. It also promotes more efficient administration. This is especially when the trustee is insolvent but the trust is solvent.

Question 9 - *Should there be a statutory order of priority in the winding up of a trust?*

Yes there should be a statutory order of priority in the winding up of trusts. This is consistent with the recommendations in the Harmer Report.[37]

The first justification for this is that statutory priority rules implement public policy. One policy in the Act for example is the principle that proven debts in a winding up rank equally and must be paid proportionately.[38] A further policy is to recognise preferential priorities.[39] This includes preferential treatment for employees on account of their vulnerability and risk of financial hardship.[40]

Similarly the *Personal Property Securities Act 2009* (Cth) ('**PPSA**') implements public policy by replacing a 'patchwork' of different statutory and general law priority rules with a statute providing uniform priority rules. It also recognises public policy by giving preferential treatment to certain types of security interests.[41]

These public policies do not offend notions of 'equity'[42] but to the contrary promote 'fair' and consistent priorities.

The second justification is that it follows the direction of the joint judgment of Bell, Gageler and Nettle JJ in *Amerind*. In particular their Honours agreed that there was no reason why the statutory order of priorities in s 556 of the Corporations Act should not be followed in distributing the proceeds of the trustee's right of indemnity among trust creditors.[43] They also considered that this was not contrary to the intent of Parliament given the wide-spread use of companies as trustees of business trusts in Australia and Parliament's enactment of s 556 against the background of Re Suco Gold and 'its general acceptance'.[44]

Question 10 - *Should a statutory order of priority replicate the regime for companies? Do additional factors need to be considered where a corporate trustee is involved?*

Generally yes the statutory order of priority should replicate the regime for companies.

However there are additional factors that need to be considered where a corporate trustee is involved. These include keeping company and trust assets separate, facilitating general principles of trust law with the priorities, and accounting for the differences between trust and non-trust creditors.

In terms of a suitable statutory order of priorities, the order of distribution recommended in the Harmer Report provides a useful starting blueprint.[45]

Question 11 - *Should there be additional limits on the enforceability of ejection clauses and/or clauses that seek to limit a trustee's right to indemnity, in situations involving insolvency or external administration?*

Question 12 – *What would be the impact of such limits?*

We answer these questions jointly.

Yes there should be additional limits on the enforceability of ejection clauses and clauses that seek to limit a trustee's right to indemnity in situations involving insolvency and external administration.

Ejection routinely increases the cost of dealing with an insolvency event.

Such clauses are commonplace and either a replacement trustee will not be promptly instituted, such that the ejected trustee remains trustee of a now bare trust, leaving trust assets not actively managed, or, a dispute arises between the ejected and the replacement trustee over priorities.

The consequences may be that the ejected trustee can no longer exercise its rights to self-help, and no longer have the rights and powers conferred on it by the relevant trust deed. These problems cause substantial obstacles for the insolvency practitioner who is appointed to the ejected trustee due to uncertainties around their power to realise trust assets

and the priority in which they must distribute them. Such a scenario also complicates the entitlement of the insolvency practitioner as to their fees and disbursements,[46] and can create disputes between the practitioner and a replacement trustee,[47] which further increases costs generally and reduces net returns to creditors.

We think that legislation should make it clear that trustee ejection clauses that operate automatically on insolvency are unenforceable, and that such legislation operates in respect of all trust instruments regardless of when the trust was established.

The freedom to remove trustees prior to an insolvency event need not be limited.

Similarly we agree with the Harmer Report recommendation that:[48]

> *A legislative provision which provides that a term or condition in a trust instrument or agreement that might have the effect of excluding or barring a company from exercising the equitable right of indemnity against trust property for debts and liabilities properly incurred by the company in the conduct of a trust be void as against the liquidator.*

This recommendation if adopted would reduce prejudice to creditors because the right of indemnity is the only way they may access the trust fund. This particularly improves the position for creditors who are unaware that the company is a trustee.[49]

We consider that legislation should clearly define the scope of the trustee's indemnity and powers to deal with trust assets so that an external administrator can approach their tasks with greater clarity and less need for Court intervention. It is essential that such legislation, if instituted, covers the field to the exclusion of both state laws and private trust deeds to promote commercial certainty for parties transacting with trading trusts.

Whilst it is possible to leave it open to parties to deal with trustee ejection and indemnity clauses in their transaction documents Parliament should not rely on parties to map out a regime in private, particularly where such regime may cause significant unknown consequences on unsophisticated small trade creditors who deal with these entities.

It is conceded that legislative change in the area would be very complex, particularly as state trustee acts have traditionally dealt with the plurality of the issues raised by this question and are not consistent in their application.[50]

In summary, limiting the enforceability of auto-ejection clauses and clauses that limit a trustee's indemnity would have beneficial, far-reaching consequences, including at least:

1. Greater commercial certainty for parties transacting with trading trusts;
2. Swifter and cheaper processes should external administration of a trading trust be necessary;
3. A greater proportion of the trust's assets being available for distribution to creditors on an insolvency;
4. Certainty for insolvency practitioners and their advisors as to the state of the law on these issues;
5. A reduction in Court applications;
6. Disincentivising 'phoenix activity'.

Beyond these immediate impacts, other adverse consequences should also be considered such as:

1. Trust beneficiaries may consider it necessary to overhaul their existing structures, which would likely result in the expenditure of significant professional fees as well as liabilities for stamp duty and capital gains tax. Fairness in this respect needs to be considered.
2. Trust that are traditionally considered to be non-trading, such as superannuation fund trustees, and Managed Investment Schemes would likely be captured by the contemplated reforms unless specific exemptions were provided.
3. The ability to replace trustees on the eve of an insolvency would likely not be affected and may indeed increase as a result of these changes. Further consideration as to limiting that behaviour, where it is used as a device to defeat the interests of creditors, is warranted.

Question 13 – *Are there any other issues that need to be considered in light of the questions above?*

At present creditors have difficulties determining whether entities they wish to trade with are carrying on business as trustee or in their own right, and the names of the trusts which they administer. Often this can mislead creditors as to the creditworthiness of the entity. Uncertainty about the entity can also lead to registration errors and risk of losing security interests under the PPSA. In some cases, creditors can also have difficulties in determining who the trustee of a certain trust is when unsophisticated parties enter into contracts using only the name of the trust as an identifier for the party's name.

Currently, trusts are not required to reveal the name of the trustee, even if an ABN is issued and the trust is otherwise searchable on ABN Lookup. This can cause problems in commencing litigation to recover a debt when creditors do not know the name of the trustee to sue.

In our view Corporate Trustees should be required to register all trading trusts in which they act as trustee under a specific searchable trust register which can be managed by ASIC. Details of the name of the trustee, the name of the trust and its ABN must be maintained and, in certain circumstances, the current trust deed must be registered.

As mentioned earlier at question 1, there should be consideration given to equivalent changes to the *Bankruptcy Act 1966* (Cth) so that there is an insolvent trust regime that applies in a similar way to personal trustees.

Question 14 – *What is the most appropriate model by which a statutory regime could be expressed in the legislation?*

We consider that the most appropriate model is insertion of a new Part in the Corporations Act that addresses the various aspects with trading trusts. That Part may appear in the existing Chapter 5 for External Administration.

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FOOTNOTES

[1] Harold Ford, 'Trading Trusts and Creditors' Rights' (1981) 13 Melbourne University Law Review 1, 1.

[2] Roderick Meagher, 'Insolvency of Trustees' (1979) 53 The Australian Law Journal 648, 653.

[3] Ibid.

[4] Ibid.

[5] Australian Law Reform Commission, General Insolvency Inquiry (Report No 45, 1988) Vol I, 108 [239] ('Harmer Report'); Dyson Heydon and Mark Leeming, Jacobs' Law of Trusts in Australia (LexisNexis Butterworths Australia, 7thed, 2006) 49 [316].

[6] New Zealand Law Commission, Court Jurisdiction, Trading Trusts and Other Issues (Issues Paper 28, December 2011) 114115 [8.32].

[7] *Trusts Act 1973* (Qld) s 57 and *Trustees Act 1962* (WA) s 55.

[8] Dyson Heydon and Mark Leeming (n 5) 48-49 [316].

[9] Ibid, 49 [316].

[10] Nuncio D'Angelo, 'The trust: Evolution from guardian to risk-taker, and how a lagging insolvency law framework has left financiers and other stakeholders in peril' (2009) 20 Journal of Banking and Finance Law and Practice 279, 281.

[11] Ibid, 280.

[12] Harmer Report, (n 5) 112-113 [252].

[13] Ibid, 113 [252].

[14] *Re Austec Wagga Wagga Pty Ltd* (in liq) [2018] NSWSC 1476 [18].

[15] *Horwath Corporate Pty Ltd v Huie* [1999] NSWSC 583 [9]-[10];

[16] *Park & Muller v Whyte* [2015] QSC 283 [19].

[17] Nuncio D'Angelo, 'When is a trustee or responsible entity insolvent'? Can a trust or managed investment scheme be "insolvent"?' (2011) 39 Australian Business Law Review 95.

[18] Ibid, 100-101.

[19] Ibid, 101. See Corporations Act s 601ND(1)(a).

[20] Ibid, 102.

[21] Ibid.

[22] Ibid, 103.

[23] Ibid, 108.

[24] Ibid, 101 and 104.

[25] Ibid, 104.

[26] Harmer Report, (n 5) 110 [245]

[27] Harmer Report, (n 5) 109-110 [243].

[28] See Roderick Meagher, (n 2) 650.

[29] Harmer Report, (n 5) 111 [247].
[30] Ibid, 110-111 [246].

[31] Ibid, 111 [246].

[32] Harmer Report (n 5) 117 [265].

[33] Case law examples include *Re Neeeat Holdings (in liq) [2013] FCA 61 and Re Suco Gold Pty Ltd* (in liq) (1983) 33 SASR 99 ('Re Suco Gold').

[34] *Re 0 Love 0 P/L* (in liq) [2021] AATA 397 is an example of this scenario.

[35] Harmer Report (n 5) 116 [262].

[36] *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth* [2019] HCA 20 ('Amerind') [97]] (Bell, Gageler and Nettle JJ) and [172] (Gordon J).

[37] Harmer Report (n 5) 116-117 [264]-[265].

[38] *Corporations Act 2001* (Cth) s 555.

[39] *Corporations Act 2001* (Cth) s 556.

[40] *Corporations Act 2001* (Cth) s 556(1)(e)-(h); Harmer Report (n 5) 294 [721].

[41] Purchase money security interests (PPSA ss 14 and 62) and security interests in accounts as proceeds of inventory (s 64) are examples of security interests receiving preferential treatment.

[42] James Allsop, 'The Intersection of Companies and Trusts' (2020) 43(3) Melbourne University Law Review 1128, 1136.

[43] Amerind (n 36) [95]. [44] Amerind (n 36) [96].
[45] Harmer Report (n 5) 116-117 [264]-[265].

[46] *McCallum v Pitard Consortium* [2021] VSC 369.

[47] Harmer Report, (n 5) 113 [254].

[48] Harmer Report, (n 5) 112 [251].

[49] Ibid, 112 [249].

[50] *Trustee Act 1925* (NSW) s 59(4); *Trustee Act 1925* (ACT) s 59(4); *Trustee Act 1893* (NT) s 26; *Trusts Act 1973* (Qld) s 72; *Trustee Act 1936* (SA) s 35(2); *Trustee Act 1898* (Tas) s 27(2); *Trustee Act 1958* (Vic) s 36(2);*Trustees Act 1962* (WA) s 71.