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Clarifying the treatment of trusts under insolvency law

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The principles outlined in this paper have not received Government approval and are not yet law. As a consequence, this paper is merely a guide as to how the principles might operate.

Clarifying the application of corporate trusts in insolvency

Introduction

The Government is committed to facilitating the successful restructure of companies, including those impacted by COVID-19, so that they can survive and go on trading.

In September 2020, the Government announced changes to Australia's insolvency framework to better serve Australian small businesses, their creditors and their employees.

These reforms, which came into effect on 1 January 2021, introduced new insolvency processes suitable for small businesses, reducing complexity, time and costs. Complementary measures were also enacted to ensure the insolvency sector can respond effectively to any increased demand and to the needs of small businesses.

Following the commencement of the small business reforms, the Government is exploring further insolvency reform to help companies in distress to reorganise and survive, while further reducing regulatory burden for business. The intent is to complement the Government's existing small business reforms, ensuring more companies can benefit from improvements to insolvency law.

The treatment of trusts under corporate insolvency law has been identified as one area for improvement. Australia's current corporate insolvency regime does not expressly cover how companies which structure themselves through a trust, or businesses which have a corporate trustee ('corporate trusts') are to be dealt with during insolvency. This differs from companies who do not employ a trust structure, which benefit from a clear statutory regime established under Chapter 5 of the *Corporations Act 2001* (Cth).

Reforms to clarify the treatment of trusts under Australia's insolvency regime could help to reduce the costs and complexities associated with dealing with an insolvent business where a corporate trust is involved. In turn, this could provide greater certainty to creditors and other parties, and support businesses to turnaround, restructure and survive. Reform could also support more businesses to access the new small business insolvency processes.

This consultation will explore whether the treatment of corporate trusts in Australia's insolvency law needs to be clarified, as well as the benefits that this could deliver. Stakeholders' views are also sought on the most appropriate way to extend Australia's statutory insolvency regime to these entities, should a case be made for legislative change.

The Government remains committed to further simplifying and streamlining insolvency law so that viable businesses that do encounter economic challenges have the opportunity to restructure and go on trading. To achieve this, the Government is also consulting on improving schemes of arrangement processes to help companies restructure. The Government has also:

- Increased the minimum threshold at which creditors can issue a statutory demand on a company, from $2,000 to $4,000; and,
- Commenced an independent review of the insolvent trading safe harbour.

These will build on the progress of the small business reforms, promoting a flexible and streamlined insolvency system. These other measures are being progressed separately to this consultation process.

Request for submissions

Written submissions are sought from stakeholders on the issues raised in this discussion paper. Submissions may be provided until 10 December 2021. Discussion questions are included to guide feedback. However, stakeholders are welcome to provide further information and suggestions relevant to the issue.

Trusts and Australia's insolvency framework

What is a corporate trust?

As noted, a corporate trust structure arises where a company acts as the trustee of one or more trusts. The matters explored in this paper only apply to trust structures with corporate trustees, unless otherwise stated.

A trust is an obligation imposed on a person or other entity in respect of property held for others. Under this arrangement, a person or company (known as the trustee) holds assets (called trust property) 'in trust' for its beneficiaries.

A trust can be thought of as a fiduciary relationship between the trustee and the beneficiary. This relationship is not a separate legal entity, but a set of recognised rights and responsibilities. This means a trust cannot incur debts, sue or be sued in its own right. The relationship operates in accordance with the trust deed, which sets out the conditions, terms and rules for establishing and managing the trust.

Taxation data from 2018-19 shows that there were over 630,000 trusts with a corporate trustee. To put this in perspective, in the same financial year there were just over one million companies that lodged tax returns. With around 313,000 of these trusts being 'trading trusts'[1], the use of trusts for business activities is very common, including among small, medium and family-owned businesses.

Trusts and insolvency

When a company that does not employ a trust structure becomes insolvent, the company and its creditors benefit from a clear statutory regime established under the Corporations Act. This sets out when the company is insolvent, the consequences of insolvency, who conducts any external administration and controls the distressed company, the rights, duties and obligations of affected parties, how the future of the distressed company is to be decided, and the order in which its debts are to be repaid in any liquidation.

No such regime exists for insolvent corporate trust structures. Rather, where a corporate trust becomes insolvent, an external administrator may apply to the court for directions on how to administer the assets and liabilities subject to the trust. The courts must rely on precedent, the general principles of trust law (primarily contained in case law), and the specific facts of the particular trust to determine how an individual trust is to be wound up. The result is that the administration of an insolvency involving a trust structure can require additional time and expensive trips to court.

This state of affairs may impact businesses and creditors in multiple ways. For example:

- The uncertainty may prevent distressed businesses involving trusts from being able to use the insolvency system to turnaround and survive.
- The pool of assets for distribution may be reduced due to the cost of court processes, or because of other delays and expenses.
- It may affect creditors' confidence to lend to trading trusts, impacting the cost and availability of credit.

From 1983 and 1988, the Australian Law Reform Commission (ALRC) conducted a comprehensive review of corporate insolvency law in Australia. The resulting 'Harmer Report' noted the difficulties involved where corporate trading trusts faced insolvency, and recommended that the law be clarified

[1] A 'trading trust' refers to a trust that carries on business activities (rather than holding solely passive investments such as shares, property and fixed interest assets).

to provide certainty. It identified matters requiring resolution and made corresponding recommendations as to how these matters might be resolved. These were:

- The power of the external administrator of a corporate trustee to administer the trust property;
- The power of the external administrator of a corporate trustee to administer not only the affairs of the company but also the affairs of the trust;
- Limitations on a corporate trustee's right of indemnity and their applicability to an external administrator;
- The circumstances in which the corporate trustee may be removed as a trustee;
- The extent to which trust property may be applied to meet the claims of creditors of the company, especially where the terms of the trust did not provide for the company to engage in the particular transactions that resulted in the liability; and
- The order of distribution of trust property among creditors.

Since the Harmer Report, other reviews have noted the increasing use of trusts as a form of business and the merit of aligning the insolvency of trusts with the regime for companies.[2]

Consultation questions

A legislative framework for insolvent trusts

As noted, it has been argued that the extension of the insolvency framework to businesses which utilise a corporate trust structure may provide greater certainty to participants where a company involving a trust structure becomes insolvent. Stakeholder views are sought as to whether such clarification would be beneficial.

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 administration processes should the amendments apply to?

Question 2: What benefits would a legislative framework deliver?

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

Key design considerations for a legislative framework

Clarifying when a trust is taken to be insolvent

Extending the legislative framework could involve clarification of when a trust with a corporate trustee is deemed to be insolvent. Doing so could provide greater certainty to creditors and other parties, and better alignment with the framework used for insolvent companies.

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

Question 5: What is the most appropriate way to prescribe when a trust is taken to be insolvent?

[2] See, for example, The Productivity Commission 2015 Inquiry Report into 'Business Set-up, Transfer and Closure' at p 433.

Clarifying the role of the external administrator

As a result of the uncertainty surrounding the power of an external administrator to administer trust assets and liabilities, external administrators commonly apply to the court for their appointment as receiver of the trust assets. This is particularly the case where a trust deed attempts to limit a trustee's right of indemnity.

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

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?

Distribution of assets

There may be benefit in expressly setting out how the assets and liabilities attributable to trusts are to be treated under external administration.

One approach could be to specify that the assets and liabilities attributable to each trust, as well as of the trustee company, are to be resolved separately. This would allow the liabilities attributable to each trust to claim against the assets attributable to that particular trust only. Likewise, liabilities incurred by the corporate trustee in its own right would claim against the assets it holds in its own right.

This approach could also include a clear statutory order of priority for repayment of liabilities attributable to trusts along the lines already contained in the Corporations Act[3] and clarification of who can claim against the proceeds of the trustee's right of indemnity and how these claims are prioritised.

Some of these issues have already been clarified in case law.[4] However, there remain difficulties presented on a case-by-case basis or in more complex corporate structures, such as corporate trustees trading as a partnership.

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

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

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

Ejection and indemnity clauses

Some trust deeds may include 'ejection clauses', which provide for the automatic removal of a trustee if an insolvency event occurs, including the appointment of an external administrator. The intent is to remove a trustee who may have become undesirable to beneficiaries as a result of insolvency or an external administration.

The operation of ejection clauses may hinder the progress of an external administration, as their effect may be to impede the external administrator's ability to efficiently and effectively administer the company and its business. While a court can make orders to suspend these clauses, this can add additional time, complexity and costs.

[3] See, for example, section 556 of the Corporations Act.
[4] See, for example, *Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth of Australia and Others* [2019] HCA 20

A trust deed may also include a clause which seeks to remove a trustee's right of indemnity in situations involving insolvency. While the courts have provided guidance as to the applicability of these clauses, it may nonetheless be beneficial to clarify this in legislation.

The Government's 'ipso facto' reforms, introduced as part of the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017*, establish an existing framework to limit the enforceability of certain ipso facto clauses. The reforms provide that ipso facto clauses triggered as a result of an insolvency event are stayed for certain contracts entered into on or after 1 July 2018.

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 impacts of any such limits?

Other issues

Views are sought on any other issues that stakeholders would like to raise in connection with this consultation process. Should this consultation support the case for legislative clarification, consideration would also need to be given as to how this would be expressed across the statute book.

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

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