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**Clarifying the treatment of trusts under insolvency law**
**Submission**

## 1 Introduction

1.1 We are a group of senior banking and finance lawyers from four large Australian commercial law firms that have substantial banking and finance practices. Among other things, we act in the negotiation, structuring and documentation of debt financing facilities across the spectrum of funding options. With one exception, we are not insolvency practitioners but much of what we do is done with a careful eye to the possibility of insolvency to ensure that, to the fullest extent possible, in the event that the borrower and/or a guarantor are affected by insolvency the regime negotiated by the parties and recorded in their transaction documents will result in relatively predictable outcomes, particularly for financiers and other creditors.

1.2 A large number of economic entities trading or investing in Australia today are structured as trusts, and many of these are registered managed investment schemes (**RMIS**). These economic entities often need to borrow or give guarantees or enter into other contracts. Their financiers and other counterparties want access to the assets of the economic entity, the trust assets, on enforcement or insolvency.

1.3 But a trust is not a legal entity. It is a set of duties imposed on the trustee who holds property for beneficiaries (or, in some cases, a charitable purpose). Any loan agreement, guarantee or other contract is entered into not by ‘the trust’ as such, but rather by the trustee, and it is the trustee that incurs the obligations and liabilities. The financiers and other counterparties enforcing those obligations and liabilities only have access to the trust assets through the trustee, and then only if the trustee has acted properly as trustee (ie in accordance with its powers and duties). If it has not, the financier or counterparty may not have a right or ability to access the trust assets or be paid out of them, *whether or not it knew or could have known that the trustee was not acting properly*.

1.4 This presents financiers and counterparties with a series of risks and challenges that do not exist when dealing with a company on its own account. Those risks and challenges can deter financiers and other parties, retarding the availability of credit to trusts or increasing its cost.

1.5 This submission is written from that perspective and out of a desire to emphasise to Treasury that, when it comes to trusts and insolvency, lawyers and participants in transactions at the 'front end' are as vitally interested in reform as those who become involved once insolvency strikes.

1.6 We fully support the Consultation and welcome the opportunity to make a submission.

1.7 We should note that others in our respective firms (including some that are insolvency specialists) may be making their own separate submissions in response to the Consultation Paper. We should not be taken as representing the collective or exclusive position of our respective firms.

1.8 Finally, we do not respond to the questions in the Consultation Paper separately. Others will undoubtedly do that. Our submission rather is of a general nature, to highlight some of the ways in which the risks posed by trusts in insolvency affect the negotiation, structuring and documentation of financing and other commercial transactions. The issues we raise were not addressed in the Harmer Report nor have they been discussed in any detail in any other official law reform report since.[1] If anything, this submission might be seen as a response to Question 13: *Are there any other issues that need to be considered in light of the questions above?*

## 2 Recommendation

2.1 For the reasons set out below, we recommend that, in addition to any amendments that might be made to the insolvency provisions of the *Corporations Act 2001* (Cth) (the **Corporations Act**) as a result of this Consultation, the Act should also be amended to insert innocent outsider (or 'indoor management') protections for persons dealing with trusts that have a corporate trustee (which would include all those that are RMIS). These provisions should correspond (as applicable) to those that benefit persons dealing with companies on their own account under sections 124 to 129 of the Corporations Act, tailored to the complexities of the trust form. Some of the matters that could and should be addressed by such provisions are discussed in paragraphs 4.2 and 5 below.[2]

2.2 These provisions would protect persons who are innocent of disentitling knowledge or suspicion against adverse consequences of internal defects in the trust and trustee misconduct, and allow them to transact with trusts and trustees with a higher degree of confidence and with lower transaction costs and risks.

2.3 Importantly, they would eliminate a range of unexpected adverse outcomes for financiers and other counterparties (and associated litigation) in the insolvency of a trustee or trust. [3]

## 3 The market and regulatory context — the contrast with companies

3.1 As noted in the Consultation Paper and elsewhere, trusts are popular and ubiquitous in Australian commercial life, due mainly to their useful structural flexibility and the legitimate taxation advantages that are available (including 'pass-through'

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[1] The 'Harmer Report' is the report of The Law Reform Commission entitled *General Insolvency Inquiry* (Report No 45, 1988). The issues are dealt with in some detail in N D'Angelo, *Transacting with Trusts and Trustees* (LexisNexis Butterworths Australia, 2020), primarily in Chapter 5.

[2] There is a number of ways these provisions could be drafted. For example, they should include nullifying the impacts of the 'clear accounts rule' on trust creditors (discussed in paragraph 5), leaving 'unrelated breaches' to be dealt with between trustee and beneficiaries. For statutory assumptions to work properly it might be necessary to create a searchable public register for trusts/trustees that wish to incur external indebtedness and that would give rise to its own set of complexities. We would be happy to discuss suggestions on request.

[3] We do not in this submission specifically address superannuation trusts and funds, which are regulated by the *Superannuation Industry Supervision Act 1993* (Cth) and several other statutes and regulatory instruments. Those trusts are not permitted to undertake full recourse borrowing (see section 67 of the Act) and so are not particularly prone to insolvency, but they do engage in investment and other commercial activities that involve transacting with external parties, so the protections we have suggested could apply to them also.

transparency).[4] They can and do engage in all of the same business activities that companies do, including borrowing and other activities that involve them incurring liabilities in favour of external counterparties.

3.2 Trusts that engage in commercial and business activities are sometimes described as 'trading trusts' or 'commercial trusts', although those are not legal terms of art and have no legal meanings within the law of trusts.

3.3 As banking and finance practitioners, we see commercial trusts virtually every day, in all manner of financing and other commercial transactions.

3.4 Typically, commercial trusts (including those that are RMIS) will be structured as unit trusts with a company as the trustee, so that they resemble and behave like companies. But they are not companies. While they may be described as business or accounting entities, they do not possess separate legal personality. They are not regulated by the Corporations Act or supervised by the Australian Securities and Investments Commission (**ASIC**) or any other regulator in the way that companies are.[5] Those who transact with them do not enjoy the benefit of the statutory creditor protections that are available to those who transact with Corporations Act companies. These differences are fundamental and enormously consequential for trust counterparties.

3.5 With some exceptions, trusts are effectively invisible to the Corporations Act – not only to the insolvency regime in Chapter 5 – and there is no equivalent statute for them.[6]

3.6 Company law provides generous innocent outsider (or 'indoor management') protections, including statutory assumptions, that benefit persons who transact and otherwise deal with a Corporations Act company acting on its own account. So long as they are not affected by disentitling knowledge or suspicion, counterparties may deal with a company with confidence, with minimal or no due diligence in relation to essential matters like existence, legal status, power, authority and internal compliance (including compliance with officers' duties), beyond obtaining and checking an ASIC search: see primarily sections 124 to 129 of the Corporations Act. From a policy perspective, this shifts certain internal risks in a company to its internal stakeholders to manage, and is an implicit acknowledgment by the state of the economic importance of companies and of protecting commercial parties that do business with them. It allows parties to deal with companies with confidence, and so enhances the ability of companies to transact and generally to do business.

3.7 By contrast, trust law provides very little in the way of protections for outsiders who deal with a trustee in that capacity. Such protections as there are in the general law are fragile and easily lost, and tend in their strictness to preference beneficiaries (who are commonly, though not always, investors) over outsiders (including creditors).[7] The relative invisibility of trusts on searchable public registers exacerbates this problem. From a policy perspective this appears to evidence an *absence* of official recognition of the importance of commercial trusts in the economy, and leaves external counterparties bearing risks that are internal to the trust, which risks ultimately may result in them having no access to trust assets on enforcement or insolvency.

3.8 For example, if a company purports to give an unsecured guarantee to a counterparty, and in doing so its directors are in breach of their duties to act in good faith in the best interests of the company and for a proper purpose, then under sections 128 and 129 of the Corporations Act the counterparty can still enforce the guarantee and participate in a distribution of the company's assets in insolvency, unless the counterparty actually knew of the breach or suspected it. By contrast, if the company is giving an unsecured guarantee as trustee, and in doing so is in breach of similar duties as trustee, the counterparty does not have any access to the trust assets, whether in enforcement or in insolvency, *even if they did not know of or suspect the breach*.

[4] See the statistics in D'Angelo, n 1, at 1.39 to 1.48.

[5] With the exception of those that are RMIS, which are *partially* regulated by the Corporations Act (mainly by Chapter 5C) and are supervised by ASIC under that Act.

[6] Even Chapter 5C itself is 'defective' from a creditor's point of view, because it contains no innocent outsider protections and no insolvency provisions. It is clearly an *investor* protection regime with little direct protection for creditors.

[7] For a comparison of the outsiders' position under the Corporations Act against their position when dealing with trusts, see D'Angelo, n 1, at 5.76 to 5.96.

## 4 What this means for financiers and others at the 'front end'

4.1 All of this means that financiers and others contemplating transacting with trustees (including commercial contracting counterparties in a non-financing context) must fend for themselves and seek protection (such as it is) by private means. But no matter how diligent they may be, those measures may still not fully protect them. They may price the risks by charging higher interest and other costs but in a competitive market that is not always feasible. Or they may only be prepared to provide a smaller amount of credit, or none at all, or impose more onerous or restrictive conditions. In any event the costs of transacting (including legal costs and management time) will be higher.

4.2 Well advised counterparties will be aware of the risks and will conduct (or have their advisers conduct) detailed pre-transactional due diligence of a kind that is not necessary when dealing with a company acting as principal, and even then this still may not give full protection. For example, they will seek to satisfy themselves that:

(1) the trust was properly formed and exists;

(2) the trust deed or constitution satisfies all formal requirements for efficacy and enforceability;

(3) the trustee is properly appointed and is the only trustee of the trust;

(4) the trustee has the trust power to hold and manage the enterprise assets in the manner in which they are being held and managed;

(5) the trustee has the trust power to enter into and perform obligations under the proposed transaction in that capacity;

(6) even if it is within power, that the transaction has been properly authorised and entry into it is a proper exercise by the trustee of those powers (eg it is in the best interests of the investors or beneficiaries, and the trustee is under no unauthorised conflicts);

(7) the trustee's entry into the transaction will not otherwise cause or result in a breach of trust;

(8) the trustee has the right to be indemnified out of trust assets for the debts and liabilities it will incur under the transaction, and that the counterparty as a trust creditor may subrogate to that indemnity on enforcement or in insolvency; and

(9) if the trust is a RMIS, it satisfies all of the formal requirements of Chapter 5C of the Corporations Act, and the trustee (or responsible entity) is not in breach of its duties and obligations under that Chapter generally or in entering into the proposed transaction. [8]

4.3 An undetected and unrectified defect, irregularity or deficiency in any of these matters, even if ostensibly only 'technical', can result in a counterparty, whether secured or unsecured, being left with no or diminished access to the assets held in the trust on enforcement or insolvency, and no other recourse of value.[9] In many cases, this outcome can apply regardless of whether the counterparty knew of or suspected the issue.

4.4 In addition to due diligence, well advised counterparties will seek to negotiate a series of trust-specific structural and documentary protections.

4.5 All of this leads to delay and added transaction costs, as well as the risk of error. It can and does occasionally lead to transactions being abandoned.[10]

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8 These steps are in addition to the normal due diligence a counterparty would conduct with respect to the trustee itself as a company.

9 They might have a personal claim against the trustee but that is worthless if the trustee is of nominal value or is insolvent or, as is commonly the case, has negotiated a robust limitation of liability clause into the documentation with the creditor.

10 And all of this can be particularly challenging to explain to offshore counterparties in jurisdictions that do not have trusts, or trusts that engage in commerce in the way Australian trusts do.

4.6 Almost none of this is required when dealing with a Corporations Act company, thanks largely to statutory protections in the Corporations Act and the availability of searchable records kept and made publicly available by ASIC.

4.7 Of course, not everyone who deals with trusts and trustees has the benefit of expert legal advice to warn them of the risks and undertake protective steps on their behalf, and so some will transact without an awareness of the risks and therefore with full exposure.

4.8 In any case, even if a counterparty does all of the above, solutions are imperfect and risks remain. Not all risks can be identified and managed by due diligence and documentation.[11]

## 5 'Unrelated breaches': an example of a risk that cannot be controlled by a counterparty, no matter how diligent

5.1 Here is an example of the limitations of protection by private means. All unsecured trust creditors (whether financiers or otherwise) face a specific risk that is unique to trusts and is virtually uncontrollable. That is the risk of 'unrelated breaches', ie breaches of trust committed by the trustee that are unrelated to the specific transaction in which the creditor is involved (for example, an unrelated misappropriation of trust funds by the trustee or the trustee making an unauthorised investment or personal gain). No amount of pre-transactional due diligence can fully protect a counterparty from these breaches. They may even be unknown to the trustee itself (it does not matter if a breach is innocent or fraudulent) and may be entirely unknowable to an outsider. They may pre-date the transaction or may occur after it.

5.2 Due to the operation of the 'clear accounts rule', these breaches can have the effect of reducing the value of the trustee's indemnity, including potentially to zero.[12] Since subrogation to that indemnity is the unsecured trust creditor's *only* route of access to the trust fund on enforcement or insolvency, these breaches may result in those creditors being deprived of recovery against enterprise assets, through no fault of their own.

5.3 For example, say a responsible entity of an RMIS (which is therefore a trustee) borrows money under a loan agreement for the purposes of the trust and at every step it acts entirely properly, in accordance with its powers and duties (as confirmed by the lender's due diligence processes). Prima facie, the lender will have access to trust assets on enforcement or insolvency. But two years before that, in an entirely unrelated transaction, the responsible entity had made a large investment that was technically not in accordance with the RMIS constitution. That investment proves unsuccessful and the losses fall on the responsible entity personally, which means it must make good by paying an amount equal to the losses into the trust fund. In those circumstances the responsible entity will have no right to indemnify itself out of trust assets against a claim under the loan agreement, unless and until it makes good. If it is unable to do that, the result may be that the lender will have no access to the trust assets on enforcement or insolvency.

5.4 Thus, even after taking steps of the type described above, unrelated breaches will always be an uncovered risk. There are limits to what a trust creditor can do, practically speaking, to prevent this or protect itself against its consequences, short of taking security over trust assets (which is not always legally possible or commercially available).

5.5 This is a stark (but by no means the only) example of where the law appears to impose the consequences of trustee misconduct on outsiders, even if they are unaware and otherwise innocent of that misconduct. In effect, equity investors in the trust (ie the

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11 Some of the uncertainties of the insolvency process when a trust is involved have recently been exposed by several high profile cases, including in the High Court: see *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth of Australia* (2019) 268 CLR 524; [2019] HCA 20. See also *Jones (Liq) v Matrix Partners Pty Ltd, Re Killarnee Civil & Concrete Contractors Pty Ltd (in liq)* (2018) 260 FCR 310; [2018] FCAFC 40.

12 The consequences for the trustee of committing breaches of this type include an obligation to restore or make good any loss caused to the trust fund, or to disgorge unauthorised profits or gains into the fund. Until it does that, it is prohibited from taking assets out of the fund for itself, including under its indemnity, unless it only takes the net amount, if any, after deducting the value of the make-good or disgorgement obligation. This is sometimes described as an obligation to 'clear the accounts' of the trust.

beneficiaries), are 'insured' in insolvency against losses caused by certain kinds of trustee misbehaviour by the trust's creditors, so that equity is preferred over debt – the exact reverse of the position when a company becomes insolvent. There is no analogue to this outcome in company law.

## 6 Conclusion

6.1 The issues described above for financiers and others dealing with trusts and trustees can only be properly resolved by legislation. It is inappropriate that they are left to be dealt with by private means. Indeed, it is extraordinary that persons who deal with a commercial enterprise that happens to be held within a commercial trust - a widely recognised, used and accepted business vehicle - suffer risks and costs, including particularly in insolvency, that do not exist for those who deal with a similar enterprise held by a company. If trusts are to be permitted to continue to conduct business in the same way as companies (and we do not suggest otherwise) then the legal risk profile of parties who do business with them should be more closely aligned to that of those who do business with companies.

6.2 We would be pleased to discuss these issues further. If you have any queries, please contact any of the following.

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