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Submission: Clarifying the treatment of trusts under insolvency law

In response to the invitation in the consultation paper released on 15 October 2021, I submit that there is a clear case for law reform in relation to the insolvent winding up of a "company" (as defined by s 9 of the *Corporations Act 2001* (Cth)) that has carried on business as a trustee.

The decision of the High Court in *Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth* (2019) 268 CLR 524 resolved some important issues about cases in which an insolvent company's activities are confined to trusteeship of a single trading trust. Other uncertainties remain. Some are identified in the judgments in *Carter Holt* itself. At [97], for example, there is reference to complications that may arise in cases where a corporate trustee has carried on business as trustee of more than one trust or as trustee of a trust and on its own account. At [56] it is noted that questions might arise about the correct order of priority between trust creditors after payment of the priority debts or about the marshalling of claims where a creditor has access to more than one fund. Observations on those questions are made at various points in the judgment of Justice Gordon.

Such difficulties and doubts cannot be left to random and piecemeal resolution as particular controversies are litigated at final appeal level. Inconsistent views often emerge in court decisions. Two generations of lawyers pored over the uncertainty generated by the fundamentally conflicting 1983 decisions of intermediate appellate courts in *Re Enhill Pty Ltd* [1983] 1 VR 561 and *Re Suco Gold Pty Ltd* 1983) 33 SASR 99 until the matter was taken in hand by the High Court in *Carter Holt*.

Nor is it satisfactory that passing observations of judges not central to courts' decisions should be the source of necessarily speculative views as to what the law might be.

Because the trading trust structure, with a company as trustee, has long been entrenched in Australian commercial life, liquidators, creditors, and others interested in the orderly administration of insolvent corporate trustees should be given by legislation the certainty and confidence that the current legal environment denies them.

At present, the *Corporations Act* compels an unhappy blending of the statutory process of winding up of the company and the non-statutory administration of the financially deficient trust estate. The tools a liquidator has are inadequate for the second of these tasks: for example, a liquidator often finds it necessary to expend scarce resources on seeking court appointment as receiver of the trust property, with consequent need for fixing of remuneration by the court.[1] This is quite at odds with the concept of winding up as a process conducted very largely without court intervention. Legislation needs to facilitate the conduct of two distinct administrations in parallel under the control of a liquidator armed with all necessary powers and without any need to approach a court except in exceptional circumstances.

Consideration should be given to the enactment of a statutory regime[2] to the effect that, in every case in which a company that has carried on business as a trustee becomes subject to insolvent winding up, the estate of the company in its own right and the estate (or estates) of the company as trustee are administered separately but concurrently by a single and adequately empowered liquidator, with the assets and liabilities applicable to each such estate being dealt with in the way contemplated by the *Corporations Act* (including as to order of application of assets) as if the separate estate were itself a company. The regime should be constructed around the basic principle that the company is liable for all debts, including those incurred as trustee, but with a right of indemnity out of trust property for the debts properly incurred as trustee, which debts are to be met out of the trust property until that property is exhausted and thereafter out of non-trust property.

The core provisions of such a regime might be along the lines outlined in the following Items 1 to 15. The outline is necessarily indicative only. If it any comprehensive proposal were to be pursued, refinement would be necessary.

1. The regime should apply to the insolvent winding up[3] of a company[4] if the liquidator determines that the sole activity or a substantial part of the activities of the company has been to carry on business as a trustee.

   Comment: Excluded, therefore, are cases of trusteeship not involving the carrying on of a business and cases of merely passive or incidental trustee activity, such as a solicitor-corporation's maintaining of a trust account.

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[1] See, for example, within the last week *Ward in the matter of PIC Lindfield 19 Pty Ltd v Zhu* [2021] FCA 1526.

[2] The regime suggested in this submission is an elaboration of a possibility briefly outlined in my paper "Trust me: Does trust property go where it should after insolvency?" presented at the 39th annual conference of the Banking and Financial Services Law Association in September 2018. The paper is accessible at: https://www.supremecourt.justice.nsw.gov.au/Documents/Publications/Speeches/2018%20Speeches/Barret t_201809.pdf

[3] "Insolvent winding up" here refers to winding up in insolvency under Part 5.4 of the *Corporations Act* or creditors' voluntary winding up, including creditors' winding up arising through Division 12 of Part 5.3A. The regime should not apply to Part 5.3A voluntary administration itself as that process does not involve the administration of assets and may lead to rehabilitation of the company. Nor is there any need for it to apply to provisional liquidation because, again, the process does not entail administration of assets.

[4] "Company" here refers to a "company" as defined by s 9 of the *Corporations Act*.

2. The central feature of the regime should be notional division of the assets and liabilities of the company into estates, with one estate (the "corporate estate") consisting of the assets held and liabilities incurred by the company otherwise than as a trustee (plus any liabilities incurred as a trustee for which the company is not entitled to be indemnified out of relevant trust assets) and each other estate (a "trust estate") consisting of the assets held by the company as the trustee of a particular trust and liabilities in respect of which the company, as trustee, is entitled to be indemnified out of those assets.

> *Comment: In the case of a liability incurred as trustee, the trust estate would include that liability if the circumstances of its incurring gave rise to a right of the company, as trustee, to be indemnified against the liability out of trust property. If there were no such right to be indemnified, the liability would belong to the "corporate estate" consisting of assets held and liabilities incurred by the company otherwise than as a trustee. Liabilities incurred as trustee for which there was a right of indemnity would also pass into the corporate estate to the extent that trust property proved insufficient to meet them.*

3. The liquidator should conduct the winding up of the company by administering all the estates separately but concurrently, with each estate being administered in the way the winding up of a company is required to be administered and as if the estate were itself a company, and with all provisions concerning winding up applying accordingly, subject to the regime itself.

4. Where, pursuant to the terms of the trust relating to a trust estate, winding up (or threatened winding up) of the company has the consequence that the office of trustee is vacated, or that a right to remove the trustee arises, or that some any other change regarding the trust occurs or can be imposed, the operation of the terms of the trust should be modified so that , in the case of insolvent winding up, that consequence does not arise.

> *Comment: If the trust assets of a trust estate are insufficient to cover the estate's trust liabilities, it is quite counterproductive for an automatic vacation of office to occur. Because of the insufficiency (the effect of which is that the trustee's right of indemnity more than absorbs the whole of the assets), the trust has no viable future, and it will be impossible, in practical terms, to find a new trustee. Insolvent administration is the only practicable course. That process should not be prejudiced or complicated by the operation of ipso facto provisions or any practical compulsion for the liquidator to seek appointment as receiver of the trust property. If, on the other hand, the liquidator concludes that the assets of a trust estate are more than sufficient to cover the trust liabilities, there should be a mechanism by which the liquidator can re-launch the trust estate and exclude it from the winding up: see Item 5.*

5. If the liquidator determines that the assets of a particular trust estate are sufficient to cover the liabilities for which the company is entitled to be indemnified out of those trust assets, the liquidator should be empowered to appoint a person to be a new trustee of those trust assets in place of the company and, on such appointment, the company should be discharged from the office of trustee, the trust assets should vest in the new trustee and the relevant estate should cease to be dealt with in accordance with the

regime. In addition, the liabilities for which the company is entitled to be indemnified out of those trust assets should cease to be liabilities of the company and be instead liabilities of the new trustee.

Comment: It may happen, at least in theory, that trust assets of a particular estate are sufficient to cover that estate's trust liabilities, even though the company is insolvent. If the liquidator determines this to be the case, the winding up should cease in relation to those assets and liabilities and the liquidator should have power to appoint a new trustee to administer the apparently viable trust into the future. The directors of the company might be given a role in the choice of the new trustee. It will be inappropriate for the company itself to be the continuing trustee since its winding up, unless terminated, will lead ultimately to dissolution.

6. The liquidator should have in relation to an estate and the assets of that estate all the powers that a liquidator has in relation to a company and the property of a company in the winding up of that company.

Comment: This would remove any remaining doubts as to the power of the liquidator to control and administer trust assets including, in particular, full power to sell. It would also ensure that limitations imposed by the terms of a trust on the trustee's power to deal with trust property did not operate to hamper the activities of the liquidator as liquidator of the relevant trust estate.

7. If the liquidator makes recoveries for the benefit of the company by way of order under 588FF, those recoveries should be allocated to a particular estate according to the capacity in which the company entered into the transaction that generated the right to recover; and the expenses of achieving the recoveries should likewise be allocated to that estate.

Comment: Under a provision of this kind, if a preferential or other transaction of the company resulted in recovery by the liquidator, the destination of the proceeds, in terms of estate, would be determined by the capacity in which the company entered into the original transaction.

8. If the liquidator makes any other recovery for the benefit of the company, the recovery (and the expenses of achieving it) should be allocated to such estate (or estates) as the liquidator considers to be equitable, having regard to the circumstances from which the right of recovery arose.

Comment: Thus, for example, if the company has, by action instigated by the liquidator, successfully pursued a right of action against directors for breach of duty, it will be for the liquidator to decide, by reference to the particular circumstances, to which estate (or estates) the proceeds should be directed.

9. Every debt and claim proved in the winding up of the company should be allocated by the liquidator to the corporate estate or to a trust estate according to the liquidator's decision as to whether it is a debt or claim to which the company's right of indemnity out of trust assets applies and, if so, according to the estate that includes those trust

assets. No debt or claim should be recognised in one estate as a debt or claim against another estate by reason of a trustee's right to be indemnified.

> *Comment: This reflects the central concept that, in the first instance, liabilities should be allocated to estates (with indebtedness between estates themselves ignored) according to the presence or absence of a right of indemnity out of trust assets. Item 11 covers the possibility that trust assets of a particular estate may prove insufficient to cover all liabilities in which there is a right of indemnity out of those assets. In that case, the surplus liabilities fall into the corporate estate. This recognizes the principle that a trustee is personally liable for all debts but entitled to indemnity out of trust property so far as it extends.*

10. All debts and claims proved and allocated to a particular estate should rank equally and if the property of the estate to which those debts and claims are allocated is insufficient to meet them in full, they should be paid proportionately; provided that debts and claims that, by force of a provision of the *Corporations Act* are, in the winding up of a company, payable in priority to all other unsecured debts and claims of the company and in an order specified in that provision shall, in the administration of the estate to which they are allocated, be paid in priority to all other unsecured debts and claims allocated to that estate and in the order specified in that provision.

> *Comment: This replicates in relation to each estate the general scheme of winding up prescribed by the Corporations Act.*

11. All debts and claims allocated to a particular trust estate should, in the first instance, be met exclusively from the assets included in that trust estate but, if those assets are insufficient to meet those debts and claims in full, the remainder should be allocated to the corporate estate, rank equally with other debts and claims allocated to the corporate estate and be administered as part of the corporate estate accordingly. Otherwise, the balance of the debts and claims allocated to one estate that remains after all assets of that estate have been applied must not be allocated to another estate.

> *Comment: See Item 9.*

12. Costs and expenses of the winding up which are not, by another provision of the regime, allocated to a particular estate or particular estates (such as the remuneration of the liquidator) should be allocated among the several estates in appropriate proportions.

> *Comment: Some appropriate principle of proportions should be prescribed by the regime. The respective gross assets of the estates might be an appropriate measure. Expenses should be defrayed out of the several estates rateably according to these proportions and, once a particular estate is exhausted, the process should continue among the remaining estates.*

13. After the assets of the corporate estate have been applied in accordance with the regime, any surplus should, after adjustment of the rights of the contributories among themselves, be distributed among the contributories according to their interests in the company.

Comment: This replicates the position in the winding up of a company.

14. After the assets of a trust estate have been applied in accordance with the regime, any surplus should be distributed among the persons having interests under the trusts of that trust estate in such manner as the liquidator deems equitable. The trusts of the trust estate will be taken to be extinguished when that distribution is complete.

> *Comment: If the assets of a particular trust estate are more than sufficient to cover its liabilities, that trust estate will likely have been excluded from the winding up and re-launched under a new trustee pursuant to Item 5. Item 14 will apply where some, but not all, of the trust assets have been absorbed in meeting trust liabilities. The fact that trust assets are depleted in that way will mean that the integrity of the trust estate's profit-making structure has been destroyed. There will therefore be no practicable alternative but to put an end to the trust and to vest the residual assets in appropriate persons. Because of the diversity of trust structures, it is not possible to prescribe appropriate destinations in any definitive way. The matter needs to be left to the liquidator who will decide what is equitable, having regard to the terms of the trust. In the commonplace case where, upon vesting of the trust, the corpus goes to one or more of named discretionary beneficiaries according to choices made by the trustee or an appointor, the liquidator may choose to have regard to those provisions and to the maxim "equality is equity". If the trust is of the unit trust type, individuals' unit holdings might be expected to indicate an appropriate basis for distribution of corpus.*

15. There should be a provision requiring the liquidator to act fairly as among the several estates and to protect the liquidator, in relation to such *inter se* matters, if the liquidator has acted reasonably and diligently. The ordinary provisions enabling a liquidator to obtain advice and direction from the court should apply. All decisions of a liquidator under the regime should be amenable to appeal and review in the same way as other decisions of a liquidator.

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Against this background, I offer the following responses to the specific questions in the 15 October 2021 consultation paper:

Question 1: Yes. A new administration process is required only in relation to the insolvent winding up of a "company" (as defined by the *Corporations Act*) which is a trustee. There is no need for any such regime in the context of voluntary administration under Part 5.3A or provisional liquidation: see footnote 3 above.

Question 2: Avoidance of uncertainty and cost.

Question 3: This question can be answered only in relation to a particularly identified extension.

Question 4: No. There is no need for a definition or concept of "insolvency" in relation to a trust as such. It is, to my mind, not meaningful to speak of insolvency of a trust of which a company is trustee, as distinct from insolvency of the company. It may be that trust property is

insufficient to allow due payment of debts for which the company, as trustee, has a right to resort to that property. But creditors – in respect of both debts incurred by the company as trustee and other debts of the company – have rights against the company only;[5] and the sole determinant of insolvency is the ability of the company to pay all those debts as they fall due from all resources available for the purpose. Trust property is available to pay trust debts but not non-trust debts; and non-trust property is available to pay both trust debts and non-trust debts. The possible approach outlined in the above Items 1 to 15 suggests how resort to the two species of property in respect of the two categories of debt might be regulated. If trust property is insufficient to pay trust debts, a situation of insolvency cannot be said to arise unless inability of the company to pay all debts exists when non-trust debts are added to trust debts and property of the company other than trust property is added to trust property.

Question 5: The question does not arise: see answer to Question 4.

Question 6: Yes: see above Items 1 to 15.

Question 7: Yes. It does not seem practicable to think of separate administration of the estate of the company as trustee and the estate of the company in its non-trustee capacity by separate functionaries – as distinct from separate but concurrent administration by a single functionary.

Question 8: Yes: see above Items 1 to 15.

Question 9: Yes. In accordance with the above Items 1 to 15, administration of the estate of the company as trustee and administration of the estate of the company in its non-trustee capacity should proceed separately but concurrently under a single liquidator and with the statutory order of application of assets – and the liquidator's powers of recovery – applying separately in the administration of each estate as they currently apply in the winding up of a company.

Question 10: Yes.

Question 11: If a "company" (as defined by s 9 of the *Corporations Act*) which is a trustee becomes subject to insolvent winding up, all provisions of the trust instrument (or other terms of the trust) that purport to prescribe some consequence, in terms of trusteeship or the terms of the trust, should be made inoperative: see the above Item 4.

Question 12: The question does not arise: see answer to Question 11.

Questions 13 and 14: See above Items 1 to 15.

Yours faithfully

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[5] A trust creditor has no interest in the trust property and no right of access to it. The creditor's rights are against the trustee only.