Clarifying the treatment of trusts under insolvency law

King & Wood Mallesons' response to Treasury

10 December 2021

1 Introduction

We refer to the Treasury document dated 15 October 2021 entitled 'Clarifying the Treatment of Trusts under Insolvency Law' (**Consultation Paper**). King & Wood Mallesons (**KWM**) has a specialist Restructuring and Insolvency team which operates nationally, with 10 partners and around 40 lawyers. We have consulted nationally and our response to the Consultation Paper is below.

2 A holistic approach to insolvency law reform

The Harmer Report, which was published in 1988 after a five-year inquiry where many of the recommendations became law in 1993 (after some government refinements), is the last comprehensive examination of all aspects of the law and practice relating to insolvency of both individuals and companies. The bankruptcy laws had been last reviewed 25 years earlier by the Clyne Report which led to the introduction of Part X of the *Bankruptcy Act 1966* (Cth).

The Harmer Report led to the introduction of voluntary administrations designed to encourage a more swift, uncomplicated, inexpensive, flexible and constructive approach to corporate insolvency with the focus on saving a business and jobs. The need for the Harmer Report arose out of the shortcomings with the law and procedure as a result of significant economic and social changes such as the extraordinary increase in the use of credit since the Clyne Report which led to an increase in the number of insolvencies. In addressing those shortcomings, regard was had to the fundamental purpose of providing a fair and orderly insolvency process by reference to overseas developments. Although the Harmer Report did not lead to the introduction of a United States-style Chapter 11 process, it was highly critical of what was described as the cumbersome, slow and costly scheme of arrangement procedures which were infrequently used and unsuited to the average company in financial difficulty.

The years since the Harmer Report have seen many "ad hoc" changes to the law, most recently in response to COVID-19. As well as amending the law, of course, governments have responded to COVID-19 by providing financial support to businesses. Along with the economic distortions caused by COVID-19, the overall result is a business/insolvency landscape in Australia - and the rest of the world - that is unprecedented in the 21st Century. After more than 30 years since the Harmer Report, it is submitted that the time has come for another comprehensive review of insolvency law in Australia. The review should seek to do what the Harmer report did 30 years ago and make comprehensive changes to Australian insolvency laws to ensure that those laws are current and practical and that they provide a workable framework for companies to restructure or for creditors to obtain maximum value from a liquidated estate.

Such a review ought to consider the important questions which are the subject of this consultation paper, namely whether any moratorium protections are required outside of those which are available during the voluntary administration process, whether reforms are required to facilitate rescue financing and whether any additional cross-class cram down mechanisms are required to prevent out of the money creditors undermining a restructure.

However, there are important other issues to consider. Numerous recent high-profile appeal cases questioning well entrenched fundamental insolvency principles (such as the peak indebtedness

rule, set offs and trusts to name a few) highlight the current legal uncertainty. The abolition of ownership and floating charge concepts following the *Personal Property Securities Act 2009* and the introduction of the Fair Entitlement Guarantee (**FEG**), Australian Taxation Office director penalty notices, trading of distressed debts / liquidator actions, safe harbour and ipso facto has only added to the complexity. This has led to innovated practices to avoid the legislative intentions such as the 'prepacked phoenix', section 440B consents, featherweight / springing securities, holding deeds of company arrangement, artificial value breaks and entrenched pre-voluntary administration second creditors' meeting funding and sales. As a result, the scale seems to have tipped too far with the more liberal system now open to abuse with associated loss of stakeholder confidence. Finally, we note that the recent reforms to the United Kingdom's insolvency law introduced in June 2020 as a response to the COVID-19 pandemic, including the introduction of the new flexible court supervised restructuring tool that is the Restructuring Plan, had long been planned and consulted upon prior to their introduction. Australia should adopt the same approach to any significant reforms.

It is submitted that such a review should consider the interests of creditors, shareholders, employees, customers/clients, directors of companies and even the interests of society.

In our view, continued piecemeal reforms targeted at perceived shortcomings with unintended consequences should be abandoned.

3 Initial hurdles to reform

Whilst our submission focuses on a number of discrete, practical issues, we identify a number of issues associated with any wholesale reform to the law of trusts as it relates to insolvency.

First, it is unclear to what extent any reform can even occur at a Commonwealth level. As it currently exists, trust law is regulated at a state level.[1] Whilst the Commonwealth retains their power under section 51(xvii) to make laws with respect to bankruptcy and insolvency, the jurisdictional issues that will inevitably arise in the regulation of insolvency of corporate trusts must be considered. It is further noted that any specific legislation addressing insolvency in the context of corporate trusts will sit alongside, and not over the top of, the general law and state trustee legislation. As such, any suggested changes to the regulation of corporate trusts in insolvency must maintain coherence with the general law and state regulation. There is no utility in wholesale change to insolvency law at the Commonwealth level if the end result is increased incoherence in the regulation of trusts generally. The High Court has on a number of recent occasions, albeit typically in the context of the law of remedies, emphasised the need to ensure coherence in the law.[2] As such, coherence should also be at the forefront of any consideration of law reform.

Second, care must be taken in any reform not to change fundamental principles of trust law. For example, any changes should not have the effect of undermining or materially modifying the trustee's duty to beneficiaries. Any insolvency reform which shifts the duty of a corporate trustee to creditors, for example, risks fundamentally undermining the institution of the trust. At front of mind of any reform to the law of trust should be the purpose of a trust and its core function as a vehicle to protect beneficiaries. Whilst its use as a corporate form cannot be ignored, it ought not to become the focus where the effects of reform which will flow to non-corporate trusts. This is particularly the case where companies which choose to structure using trusts have the option of alternate corporate forms since there is no equivalent choice for individuals.

Last, there are limits to the extent of codification of law in this area. The law of trusts is incredibly dynamic, not least due to attempts to use and adapt trusts to constantly changing circumstances.[3]

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[1] See eg, *Trustee Act 1925* (NSW).

[2] See eg, *Miller v Miller* (2001) 242 CLR 466, 479-82 [93] – [102] (French CJ, Gummow, Hayne, Crennan, Kiefel and Bell JJ); *Equuscorp Pty Ltd v Haxton* (2012) 246 CLR 498, 518 [33] – [34] (French CJ, Crennan and Kiefel JJ).

[3] See eg, the recent NSWCA case of *Ludwig v Jeffrey (No 4)* [2021] NSWCA 256, [84] (Emmett AJA, Meagher and Brereton JA agreeing) which held that where the High Court has stated that a trustee "should" seek legal advice, this does not give rise to a legal obligation to do so.

Attempts to codify trust law have been limited[4] and typically focused on specific types of trusts such as superannuation trusts.[5] As such, whether insolvency reform can be codified in the context of trusts remains unclear.

4 Responses to specific queries in Consultation Paper

The Consultation Paper called for submissions on a number of issues in relation to the treatment of trusts in insolvency. KWM's submission focuses on three issues: (2) Should the insolvency practitioner's power of sale of trust assets be legislated or automatic subject to a contrary order by a court (questions 6-7); (2) Should there be any changes to the current position on how assets are to be distributed in the winding up of a trust? (questions 8-10); and (3) How should the law be amended to protect insolvency practitioners' rights of remuneration and reimbursement of fees (question 13).

4.1 Power of Sale

In our submission, facilitating a power of sale to be exercised by insolvency practitioners should be streamlined. One method for achieving this suggested in the consultation paper is express permission in legislation. Inclusion of provisions which provide for an insolvency practitioner to administer the trust assets is sensible for a number of reasons outlined below. Similarly, the proposal in consultation question 7, that subject to a contrary order by a court, the same insolvency practitioner should be able to administer both the company, and the assets and liabilities attributable to any trusts for which the company is trustee is pragmatic and reflects the reality of insolvencies of corporate trustees.

A review of recent decisions relating to insolvency practitioners' applications to exercise their power of sale over trust assets show the Court's willingness to grant these orders without any real hesitation. The orders sought and the nature of applications appear relatively formulaic in this regard. For example, the orders sought in these applications take a very standard form:

1. *"Pursuant to section 90-15 of Schedule 2 of the Corporations Act 2001 (Cth) that the Liquidators are justified and acting reasonably in proceeding on the basis that:*
    a. *[Company] carried on business in its capacity as trustee of the [Trust]; and*
    b. *All assets and undertakings of [Company] are properly characterised as property held by [Company] in its capacity as trustee of the Trust.*
2. *Pursuant to [Relevant Section] of the Trustee Act that [Company] shall have the power to act as trustee of the Trust in accordance with terms of the Trust Deed and to deal with, hold, apply and/or distribute the Trust Property in accordance with Parts 5.5 and 5.6 of the Corporations Act 2001 (Cth).*
3. *Pursuant to section 90-15 of Schedule 2 of the Corporations Act 2001 (Cth) that the Liquidators are justified and otherwise acting reasonably in proceeding on the basis that they can deal with, hold, apply and/or distribute the Trust Property in accordance with Parts 5.5 and 5.6 of the Corporations Act.*
4. *Under section 1318 of the Corporations Act and/or [Relevant Section] of the Trustee Act that the Liquidators be relieved from any liability for:*
    a. *Having dealt with or realised the Trust Property;*
    b. *Having made payments from the proceeds of any such realisations,*

    Between the date of their appointment as administrators of [Company] and the date of this order.
5. *Pursuant to section 90-15 of Schedule 2 of the Corporations Act that the Liquidators are justified and otherwise acting reasonably in proceeding on the basis that:*

[4] New Zealand's limited attempt being one example.

[5] See eg, the Commonwealth superannuation legislation, *Superannuation Act 1922* (Cth); *Superannuation Act 1976* (Cth); *Superannuation Act 1990* (Cth); *Superannuation Act 2005* (Cth).

a. *The liquidators are entitled to be paid from the Trust Property their remuneration, costs and expenses properly incurred in preserving, realising or getting in the Trust Property, or in distributing the Trust Property, or in conducting the administration and liquidation of [Company]; and*

b. *The remuneration and expenses include the remuneration, costs and expenses of and incidental to this application and are to be paid in accordance with the priority specified in section 556(1) of the Corporations Act."*

The Court has even made comments about these applications and the orders sought, describing them as 'unremarkable'. [6]

So long as insolvency practitioners prove to the Court that they have undertaken investigations to understand the nature of the business, including whether it operates solely as a trustee, the number of trusts it administers, and the nature of any claims, the Court is willing to grant the orders sought. In our experience, this level of investigation is conducted very early in an administration by insolvency practitioners and as such, the Court is not imposing a difficult barrier in the place of granting the orders sought.

The cost for these types of applications may exceed $30,000. This includes costs associated with solicitors' fees, barristers' fees, and court fees. In KWM's experience, this preparatory work culminates in proceedings which do not typically exceed 1 hour.

Our submission is that given the formulaic nature of these applications and the significant costs involved, the process ought to be streamlined. The Treasury has suggested this could be achieved through inclusion in legislation and in our submission, this method for streamlining the process is sensible.

4.2 Asset Distribution in Winding up of a Trust

In our submission, there is no need to introduce a statutory order of priority in the winding up of a trust. This is because much of the ambiguity around distribution of assets in the winding up of a trust has been clarified in recent case law. The position established in the case law also reflects a normatively sound position and as such, no change is needed by way of statutory intervention.

Two key cases have together clarified the treatment of asset distribution in the winding up of a trust. The leading authority now is the High Court's decision in *Carter Hold Harvey Woodproducts Australia Pty Ltd v Commonwealth* (2019) 268 CLR 524 (***Re Amerind***). Prior to the High Court's decision in *Re Amerind*, the key authority was the Full Federal Court's decision in *Jones v Matrix Partners Pty Ltd* (2018) 260 FCR 310 (***Jones***).

Whilst there is no doubt that prior to these decisions there remained significant doubt about the distribution of trust assets in insolvency, an investigation into the Court's treatment of the two key authorities reveals that the principles have been consistently applied and little ambiguity remains in most scenarios. Whilst there does exist some academic commentary which critiques the extent to which these decisions have actually clarified the law, the main argument is that many of the principles arise in obiter comments.[7] Whilst this is not disputed, the argument remains academic given lower courts have applied these principles without much hesitation.

The judgments in *Jones* and *Re Amerind* have been cited approximately 80 and 60 times, respectively. A detailed consideration of a sub-set of these cases highlights how courts, particularly single judge Federal Courts and State Supreme Courts, have understood the principles arising from both cases.

The principles can be summarised as below:

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[6] *Re Garrows Close Pty Ltd (in liq)* [2021] FCA 505, [4] (Beach J).

[7] See eg, Garry Hamilton, 'Recent Developments: Amerind – The Aftermath: Questions and Practical Difficulties Remaining' (2019) 27 *Insolvency Law Journal* 185. 187 – 91; Andrew Vella, 'How much wood would a woodchuck chuck? The High Court's decision in Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth' [2019] July *Australian Banking & Finance Law Bulletin* 86, 88 – 9.

- The trustee's right of exoneration is not held on trust for the beneficiary. Instead, it is held legally and beneficially for the trustee;
- The trustee's right of exoneration takes priority over the proprietary rights of the beneficiary;
- The distribution of assets upon a sale of trust property follows the principles in *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99, that is, where there are multiple trusts which share a common trustee which goes insolvent, the assets from a trust can only be used to discharge liabilities for *that* trust;
- The distribution of trust property where the trustee is a corporate trustee is to follow the priority regime in the *Corporations Act 2001* (Cth); and
- Liquidators of an insolvent trustee cannot access the trust property without an order from the Court.

The treatment of the key authorities by lower courts effectively answers the questions in the consultation paper and it is submitted that the result is normatively sound. There already exists a statutory order of priority in the winding up of a trust and it is the same as which exists for corporations under the *Corporations Act 2001* (Cth). In fact, this was one point on which all judges in *Re Amerind* agreed.[8]

Further, the High Court's discussion of the normative justification for the reason is accepted as sound. In summary, the High Court's stance on the justification for applying the statutory waterfall for priorities can be traced to public policy reasons. As Bell, Gageler and Nettle JJ asserted, 'it would be perverse if the *Corporations Act* operated to deny employee creditors a particular priority over the holders of a circulating security interest solely for the reason that the company which employed them was, perhaps even unknown to the employees, trading as a trustee'.[9] In our submission, this argument is correct. Particularly in the Australian landscape in which so many businesses operate using a trust structure, in the absence of a statutory register of trusts as exists for personal property securities, it is extremely difficult for lay-persons, including employees, to appreciate the differences and consequences arising from this corporate structure. As such, if only for consistency, there is no reason to depart from the statutory waterfall in the context of corporate trusts.

Importantly, this is not to say that the priority regime in the *Corporations Act 2001* (Cth) is without flaw but rather that those flaws infect all corporations regardless of structure. Any flaws that Parliament or the Courts wish to fix should be changes for all corporate structures. If the statutory distribution is to change, its impact will automatically flow to corporate trusts given the High Court's decision in *Re Amerind*. Proposed changes to the statutory waterfall generally are beyond the scope of this submission.

4.3 Insolvency Practitioners' Remuneration and Reimbursement

In our submission, the main issue relating to insolvency practitioners' remuneration and reimbursement has been clarified. Whilst prior to *Re Amerind*, there were a number of disputes about whether insolvency practitioners were entitled to remuneration in priority to other creditors,[10] the High Court's endorsement of the application of section 556 of the *Corporations Act* to distribution of assets of trusts has clarified their priority.

One issue which remains yet to be clarified is whether 'the right of exoneration, and by extension remuneration of an insolvency practitioner, extends to all work carried out in the administration of an insolvent trustee, regardless of whether such work is referrable to the trust property'.[11] However,

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[8] *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth* (2019) 268 CLR 524, 551 [56] (Kiefel CJ, Keane and Edelman JJ), 568 [96] (Bell, Gageler and Nettle JJ), 584 [153] – [154] (Gordon J).

[9] *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth* (2019) 268 CLR 524, 553 [58] (Bell, Gageler and Nettle JJ).

[10] See eg, *Re Independent Contractor Services (Aust) Pty Limited (in liq) (No 2)* (2016) 305 FLR 222, 231 [25] (Brereton J); *Kite v Mooney* [2017] FCA 653, [139] – [141] (Markovic J) which held that the priority regime in the *Corporations Act* did not apply.

[11] *Australian Securities and Investments Commission v Marco (No 9)* [2021] FCA 1306, [57] (McKerracher J).

in our submission, this is a discrete question to be answered by the Court once it is required, and ought not to be interrupted through statutory intervention.