Law Council
OF AUSTRALIA

Business Law Section

Clarifying the treatment of trusts under insolvency law

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About the Business Law Section of the Law Council of Australia

The Business Law Section was established in August 1980 by the Law Council of Australia with jurisdiction in all matters pertaining to business law. It is governed by a set of by-laws adopted by the Law Council and the members of the Section. The Business Law Section conducts itself as a section of the Law Council of Australia Limited.

The Business Law Section provides a forum through which lawyers and others interested in law affecting business can discuss current issues, debate and contribute to the process of law reform in Australia, as well as enhance their professional skills.

The Law Council of Australia Limited itself is a representative body with its members being:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar
- Law Firms Australia
- The Victorian Bar Inc
- Western Australian Bar Association

Operating as a section of the Law Council, the Business Law Section is often called upon to make or assist in making submissions for the Law Council in areas of business law applicable on a national basis.

Currently the Business Law Section has approximately 900 members. It currently has 15 specialist committees and working groups:

- Competition & Consumer Law Committee
- Construction & Infrastructure Law Committee
- Corporations Law Committee
- Customs & International Transactions Committee
- Digital Commerce Committee
- Financial Services Committee
- Foreign Corrupt Practices Working Group
- Foreign Investment Committee
- Insolvency & Reconstruction Law Committee
- Intellectual Property Committee
- Media & Communications Committee
- Privacy Law Committee
- SME Business Law Committee
- Taxation Law Committee
- Technology in Mergers & Acquisitions Working Group

As different or newer areas of business law develop, the Business Law Section evolves to meet the needs or objectives of its members in emerging areas by establishing new working groups or committees, depending on how it may better achieve its objectives.

The Section has an Executive Committee of 11 members drawn from different states and territories and fields of practice. The Executive Committees meet quarterly to set objectives, policy and priorities for the Section.

Current members of the Executive are:

- Mr Philip Argy, Chairman
- Professor Pamela Hanrahan, Deputy Chair
- Mr Adrian Varrasso, Treasurer
- Mr Greg Rodgers
- Mr John Keeves
- Ms Rachel Webber
- Ms Caroline Coops
- Dr Elizabeth Boros
- Mr Clint Harding
- Ms Shannon Finch
- Mr Peter Leech

The Section's administration team serves the Section nationally and is based in the Law Council's offices in Canberra.

For further information

This submission responds to the consultation paper – *Clarifying the treatment of trusts under insolvency law*, published by the Commonwealth Treasury on 15 October 2021.[1]

The submission has been prepared by the Insolvency and Restructuring Committee of the Business Law Section of the Law Council of Australia.

The working group of the Committee which was responsible for preparing this submission comprised–

- Mr Scott Butler
- Mr Carl Möller
- Ms Carrie Rome-Sievers
- Ms Bernice Ellis
- Mr David Goldman

The Section would be pleased to discuss any aspect of this submission.

Any queries can be directed to the chair of the Committee, Scott Butler, on 0448 939 439 or at Scott.Butler@hallandwilcox.com.au.

With compliments

Philip Argy
Chairman, Business Law Section

https://treasury.gov.au/consultation/c2021-212341

Overview and observations

1. In 1988, the Australian Law Reform Commission undertook a review of Australia's insolvency laws. Its report – the ***General Insolvency Inquiry*** report, commonly known as the Harmer Report – made (in chapter 6) several concise, sensible and necessary recommendations for reforms dealing with corporate trading trusts.[2]

2. Those reforms were not implemented.

3. The use of trading trusts with corporate trustees continues to be a widely-used model of commerce in Australia. How insolvency law and trust law intersect and collide has been problematic. It has produced considerable uncertainty, litigation, and an enormous number of (sometimes conflicting) judgments across all Australian jurisdictions. But worst of all, the uncertainty and need for litigation imposes considerable additional cost in external administrations, which is borne ultimately by the few remaining assets to the detriment of creditors and beneficiaries.

4. Clarity, and a fair and prudent approach implemented nationally, would reduce unfairness and unnecessary expense, and achieve more just outcomes for stakeholders.

5. It is time for such reform.

6. The Insolvency and Restructuring Committee (**Committee**) supports the adoption of the recommendations made in chapter 6 of the Harmer Report. However, because of developments in the law since 1988, we recommend several adjustments and additions to the Harmer recommendations.

7. In summary, the Committee's key recommendations are:

   (a) The Harmer recommendations should be adopted (with some revisions to reflect developments since they were made).[3]

   (b) In a liquidation, for "simple" trusts, to the extent that the trust assets have become the property of the company by operation of the trustee's right of indemnity, the proceeds of the right of indemnity should be distributed to all creditors – that is, both to "trust creditors" **and** "non-trust creditors".[4]

   (c) The nation-wide position on other points of difficulty or uncertainty in the external administration of trustee companies (including the treatment of preference recoveries in the trust context and the right of possession of trust assets where a new trustee has been appointed) should be clarified.[5]

8. The Committee has considered the merits of treating trusts in insolvency as if they were separate economic entities. But it does not think such an approach is necessary

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2 Report No 45, 1988.
3 See discussion under "The eight Harmer Recommendations" below.
4 See "Recommendation (5): Distribution of proceeds of right of indemnity" below.
5 See "The Committee's further recommendations" below.

and, for the reasons discussed below[6], believes there are considerable issues to be overcome in doing so. Treating trusts as separate economic entities in insolvency would mean a departure from the long-standing principle of trust law that, both in and out of insolvency, a trust is not a separate entity but rather a network of obligations and relationships between legal entities. See further our comments under Recommendation 9 below.

The Committee's answers to Treasury's questions

9. The *Clarifying the treatment of trusts under insolvency law* consultation paper posed several questions. This section summarises the Committee's answers to those questions.

Question	**Committee position**
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?*	Yes, although the framework should not provide for the external administration of trusts as if they were separate entities. We support amending the existing regime expressly to address the existence of trusts and how the external administration of a corporate trustee should be conducted. The amendments should apply to all external administration processes to which corporate trustees can become subject. The fact that these companies are or were trustees, and hold trust assets, should no longer be ignored but should be addressed and clarified expressly in legislation. Unless such amendments are made, the ongoing depletion of remaining assets in expenditure on legal advice and Court applications will continue. If the legislature lays down clear rules for how trusts and trust assets are to be treated, much of this expense can be avoided for the benefit of creditors and, where there is a surplus, beneficiaries. The Courts' supervisory jurisdiction, and the scope for appropriate applications made to Court for directions, would remain.

[6] See discussion in "Recommendation (9): Trusts as separate economic entities in insolvency?" below.

Question 2: *What benefits would a legislative framework deliver?*	The benefits include clarity, certainty, greater efficiency and reduced costs. The reforms recommended below would also achieve fairer outcomes for many creditors, who often have no way of knowing if the company they are dealing with is a trustee or in what capacity it is acting. The reforms will avoid "snakes and ladders" outcomes for creditors, which are arbitrary and unjust. These benefits and the better preservation of remaining value make sensible reform preferable for all stakeholders in a failed enterprise – employees, creditors, directors, beneficiaries/investors, insolvency practitioners, and government.
Question 3: *Is there potential for detrimental or unforeseen impacts if the statutory regime is extended?*	As explained above, we do not support "extending" the statutory regime to apply to trusts as if they were separate entities. Instead, we support amending the statutory regime to expressly address the use of trusts, and how the external administration of a corporate trustee is to be conducted. The s 447A-esque power that we propose could be used to address any detrimental or unforeseen application of the default provisions we have recommended. The Court's supervisory jurisdiction could be engaged to ensure a just result in any particular case.
Question 4: *Should legislation expressly set out when a trust is deemed to be insolvent?*	No. This would only be necessary if trusts were to be dealt with as separate economic entities in insolvency and it was possible to make an insolvency appointment to a trust, separately from its trustee. We do not support that approach. In less common cases, indeed in any case, if it is desirable to appoint a separate external administrator to trust assets, the power already exists – by appointment of a receiver by the court. In practice, in the majority of cases the receiver is already the liquidator of the trustee company.
Question 5: *What is the most appropriate way to prescribe when a trust is taken to be insolvent?*	See our answer to question 4 above.
Question 6: *Should the power of an insolvency practitioner to administer the trust assets and liabilities be expressly provided for in legislation?*	Yes, in their capacity as external administrator of a trustee company.

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?*	Yes. But we do not recommend trusts be dealt with as separate economic entities in insolvency. Rather, we recommend clarification and improvements to what is already done, to improve efficiencies, reduce costs, and achieve more just outcomes.
Question 8: *Should the affairs of a trustee company and each trust it administers be resolved separately in external administration?*	No, in the "simple" case, where the trustee company's only role was to act as trustee. Yes, in more complicated cases, such as where the trustee acts as trustee of multiple trusts or intentionally acts in its own capacity. See *Recommendation (5): Distribution of proceeds of right of indemnity* below
Question 9: *Should there be a statutory order of priority in the winding up of a trust?*	A statutory order of priority already exists in the winding up of companies. The current regime ought to apply to the distribution of proceeds from the exercise of the right of indemnity.
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?*	Yes, and yes. See *Recommendation (5): Distribution of proceeds of right of indemnity* below.
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?*	Yes, see paragraphs 18-24 below.

Question 12: *What would be the impacts of any such limits?*	The unenforceability in liquidation of clauses that seek to limit or exclude a trustee's right to indemnity will mean that creditors, whose rights hinge upon this right and who had no say in or knowledge of the clause, will not be unfairly prejudiced. Unenforceability will also reduce the potential for the phoenixing (since such clauses can enable trust debts to be left with a former trustee with an inability to recover payment from trust assets held by a new trustee). The unenforceability of ejection or *ipso facto* clauses upon external administration (unless a new trustee is appointed) will mean the external administrator retains powers under the trust deed to deal with trust assets. Accordingly, there will be less need to obtain Court orders conferring powers of sale or appointment as receiver.
Question 13: *Are there any other issues that need to be considered in light of the questions above?*	Yes. These are addressed in our eight recommendations: (1) Establish a searchable register of trusts (2) Public documents and negotiable instruments (3) Intent to sell trust assets to be notified to beneficiaries (4) Right of possession of trust assets (5) Distribution of proceeds of right of indemnity (6) Preference recoveries (7) Other reforms to protect beneficiaries / unitholders (8) Statutory indoor management rule
Question 14: *What is the most appropriate model by which a statutory regime could be expressed in the legislation?*	The Committee recommends amendments to the existing regime in the *Corporations Act 2001* (Cth) (**Corporations Act**) to reflect our recommendations. We do not support the creation of a new regime. The improvements we suggest are designed to clarify and improve current law and practice, by codifying the rules around the treatment of trusts in the context of the external administration of their trustees. We think they will greatly reduce the burden on the Courts and the depletion of remaining assets, without adding unnecessary new requirements or burdens to existing insolvency regimes.

Submission

The eight Harmer recommendations

10. This section discusses the eight recommendations made in the Harmer Report about corporate trading trusts, together with additions and adjustments that the Committee recommends.

11. The Harmer recommendations are identified, with the additions and adjustments discussed below each.

(1) An insolvent company's affairs should include those as trustee

> *That there should be 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.*[7]

12. The Committee agrees.

13. Further, this recommendation should extend to all liquidations and other external administrations, not only those in insolvency.[8] It must be clear that an external administrator can control all aspects of a company's business activity, including its activity as a trustee and the assets used in and generated by this activity.

(2) Power to deal with property

> *That any reference in the [Corporations Act] 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.*[9]

14. The Committee agrees.[10]

15. Further, the Committee recommends that:

(a) there should be legislative provision confirming that the proprietary interest in "trust" property generated by a trustee or former trustee's right of indemnity is property of the trustee or former trustee;[11] and

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7 At [245] of the Harmer Report.

8 For example, companies are often wound up on the just and equitable ground, such as in oppression cases, and in cases of fraud where the applicant has moved fast to apply to protect the remaining assets, rather than follow the statutory demand process and subsequent application to wind up in insolvency.

9 At [247] of the Harmer Report.

10 This reform is, presciently, a natural consequence of the High Court's decision in the receivership context in 2019 that trust assets are "property of the company" pursuant to s 433 of the Corporations Act to the extent that a trustee company has a beneficial interest in them: see *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth* [2019] HCA 20; 368 ALR 390 at [60], [95] and [98] per Bell, Gageler and Nettle JJ, and at [107] and [141] per Gordon J; see also at [55] per Kiefel CJ, Keane and Edelman JJ.

11 Confirming the position which has finally been largely (although not with unanimity) clarified at common law.

(b) this reform should extend to all external administration processes, not only those in insolvency.

16. Clarifying that the definition of "property of the company" extends to all the winding up provisions - including s 477[12] - will solve an ongoing problem arising from the lack of clear power for liquidators to deal with and sell "trust assets". The uncertainty has spawned many, many Court applications (in particular, for the appointment of liquidators as the receivers of trust property, with power to sell or dispose of it). Such applications are expensive (in our experience, even straightforward, uncontested cases cost at least $10,000 and often more), consume valuable Court time and resources, and in most instances would be unnecessary if the legislation conferred the requisite power of sale.

17. This is so even though, in most cases, the trustee or former trustee's beneficial interest in the assets (generated by its right of indemnity) will most often entirely displace the beneficiaries' interest.[13]

(3) No exclusion [or limitation] of the right of indemnity.

> *That any 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 against the liquidator.*[14]

18. The Committee agrees and recommends extending this reform not just to exclusions but also limitations on the right of indemnity in trust deeds. It should also apply to voluntary administrators and managing controllers appointed to the trustee or its assets.

19. The potential for exclusion of a trustee's right of indemnity should be eliminated because it unfairly prejudices creditors who had no say in – nor knowledge of – the terms upon which the trustee accepted appointment. The creditors' prospects of recovery hinge entirely upon the availability of the indemnity.

20. The ability to exclude or limit a trustee's right of indemnity remains a problem in some states including Victoria, Western Australia and potentially Tasmania, due to differences between state trust legislation.[15]

21. There should be national uniformity on the issue, which will likely require cooperation of the States and Territories. The same is true of several of the recommendations.

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12 By which powers are conferred upon Court-appointed liquidators.

13 Where the beneficiaries' interest is not displaced entirely, the proportion of trust assets or their proceeds to which beneficiaries are entitled remains impressed with the trust and the liquidator will be bound to distribute the surplus to any new trustee or otherwise at the beneficiaries' direction.

14 At [251] of the Harmer Report.

15 See *Franknelly Nominees Pty Ltd v Abrugiato* [2013] WASCA 285 at [221], [229], [235]-[242] and *RWG Management Ltd v Commissioner for Corporate Affairs (Vic)* [1984] VR 385, 395, 401; see also Campbell J, *The New Section 100A Trustee Act (NSW): When a Beneficiary is Personally Liable to Indemnify a Trustee* [2020] USydLRS24; (2020) 14:2 Journal of Equity 103 at fn 5.

(4) No ipso facto ejection

That if a company is acting as trustee of a trust and becomes subject to any application for winding up in insolvency, any provision in the trust instrument allowing for the removal of the company as trustee shall have no effect. The liquidator or administrator would be able to cause the company to resign as trustee and the court would retain the power to remove the trustee.[16]

22. The Committee agrees. Further, it recommends that:

    (a) this reform should apply to the commencement of (or application for) all forms of external administration;

    (b) there should be legislative provision that any attempt by an appointor to change the trustee after an external appointment commences or an application for one is made is void, unless made with Court approval or the consent of the external administrator. The provision could prescribe factors relevant to that approval or consent, including that the new trustee has satisfied or made provision for the satisfaction of the former trustee's trust liabilities;

    (c) if the legislature is inclined to continue to permit some *ipso facto* ejections of trustees (that is, the automatic removal of the company as trustee by reason of it going into a form of external administration), there should be a provision that such clauses can only operate as from the appointment of a replacement trustee, rather than leave a trust with no trustee. Such a provision would not fetter the power of the appointor to replace the trustee prior to the commencement of or application for an external administration, so long as a replacement trustee is appointed.

23. To some extent, the *ipso facto* law reforms, introduced by the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* (Cth) and related statutory rules, which affected post-1 July 2018 contracts and deeds, will have achieved these goals. But those reforms do not affect pre-1 July 2018 trust deeds. They also contain many exceptions. The Committee's view is that *ipso facto* removal of trustees should be barred for all trust deeds.

24. In any circumstance where the trustee has outstanding liabilities that it incurred in a trustee capacity, it is good policy for it to remain as trustee if it becomes subject to external administration. This will help ensure as just an outcome for trust creditors as possible and reduce the potential for phoenixing activity.

(5) Collective right of indemnity

That upon the insolvency of a corporate trustee, the exercise of the right of indemnity against both the trust property and the beneficiaries (if such a right exists) should be a collective right exercisable by the company, through its liquidator, on behalf of all trust creditors, subject to any order of the court.[17]

16 At [258] of the Harmer Report.
17 At [261] of the Harmer Report.

25. The Committee does not support this recommendation. The need for this reform, as foreseen in 1988, has not manifested.

(6) Distribution of proceeds amongst creditors

> *That the following should apply to the distribution of trust property:*
> *a. Company and trust property to be kept separate,*
> *b. Order of payment - Costs of the exercise of the indemnity and administration of associated property, then winding up costs to the extent that the company's own assets are insufficient, then trust creditors in the order of statutory priorities. Any deficiency in claims of trust creditors to be admissible to share in the company's general estate,*
> *c. The right of indemnity is extended to include not only the amount of 'trust' debts and liabilities, but also the total costs associated with the winding up of the company.*[18]

26. The Committee makes a different recommendation about the distribution of proceeds of enforcement of the right of indemnity. The Committee recommends that default provisions should set out the rules of distribution in specific categories of cases. These should achieve clarity, simplicity, and the most just outcome for all stakeholders and avoid the current need for Court applications. In most cases, applying the rules will be straightforward, and the Court's supervisory jurisdiction over trusts need not be engaged.

27. The Committee's recommendations on distribution are set out below, under the heading "*Recommendation (5): Distribution of proceeds of right of indemnity*".

28. We recommend there should also be a provision, similar to that in s 447A of the Corporations Act, that allows the Court to vary the operation of the default provisions in a particular case. There should also be a provision that outlines the objects for the treatment of trusts, which would then inform the use and application of the s 447A-esque power.

(7) Voluntary Administration

> *That so far as is relevant, any reforms relating to corporate trading trusts should also be made applicable to trustee companies under administration.*[19]

29. The Committee agrees. Any reforms should extend to all external administrations of trustee companies, including receiverships over trust assets.

(8) Bankruptcy

> *That amendments to the legislation relating to corporate trading trusts should, so far as is relevant, also be made applicable to the situation of an individual trustee who becomes a bankrupt.*[20]

30. The Committee agrees.

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18 At [265] of the Harmer Report.
19 At [271] of the Harmer Report.
20 At [270] of the Harmer Report. That these amendments are needed in bankruptcy too is illustrated by the *Lane* run of cases, see for example *Commissioner of Taxation v Lane* [2020] FCAFC 184; 385 ALR 92.

The Committee's further recommendations

31. The Committee's further recommendations are as follows:

Recommendation (1): Establish a searchable register of trusts

32. A public, searchable register (or database) of trusts should be established, that displays the ABN (or other unique identifying number) and the current trustee for each trust.[21] Such a register would assist creditors by reducing the scope for confusion about whether or not they are dealing with a trustee and of which trust.

33. Such registers are a familiar feature of the commercial landscape. The existing "ABN lookup" facility identifies where the holder of an ABN is a trustee. But it does not name the trustee. Further, no existing public register allows a creditor to ascertain whether a company with which it is dealing is a trustee.

34. To capture the searchable data, it could be a requirement that a corporate trustee have to file a notice with ASIC (or elsewhere), containing relevant information about the trust, when it is appointed trustee of a trust and when it ceases to be a trustee of a trust.

Recommendation (2): Public documents and negotiable instruments

35. Creditors should be able to identify that they are dealing with the trustee in its capacity as trustee of a trust and which trust. Therefore, when acting as trustee of a trust, a trustee should be required to set out the name and ABN of the trust in all its public documents and negotiable instruments that relate to that trust.[22] This will assist creditors and insolvency appointees, especially in determining whether liabilities incurred by a company are incurred in its own capacity or as trustee.

36. This proposal is similar to the proposal contained in [2.105 to 2.110] of the Exposure Draft Explanatory Materials to the *Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2021: Regulatory Framework* published by Treasury.

Recommendation (3): Intent to sell trust assets to be notified to beneficiaries

37. Even if trust debts exceed trust assets (such that the trustee company's proprietary interest in the assets entirely displaces the beneficiaries' interest), beneficiaries may wish assets to be retained by the trust or by themselves for sentimental or other reasons, particularly for real estate.

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21 Consideration should also be given as to whether, for AML/CTF purposes, a list of beneficial ownership should also be kept on the register. In Ireland, a trusts register by way of a central register of beneficial ownership of trusts commenced in October 2021.

22 The Corporations Act already provides, in s 153, that a company must clued its name and Australian Company Number (ACN) on all its public documents and negotiable instruments. "Public document" is defined in s 88A.

38. Therefore, there should be an opportunity for beneficiaries to pay the trustee or former trustee market value for the assets so that they or their value is retained in the trust, or to apply for Court orders prior to the sale occurring if they object to the sale.[23]

Recommendation (4): Right of possession of trust assets

39. If a company holds trust assets when a new trustee is appointed, the Corporations Act should provide that it is entitled to retain possession of the trust property to enforce its right of indemnity, until the right has been satisfied or secured. This should apply whether the company is subject to any external administration or winding up application or not.

40. Whilst the right to retain trust assets as against beneficiaries for enforcement of the right of indemnity is clear in equity, the right to retain as against a new trustee is not. There is a controversy between competing lines of authorities, and the current view tends against a right to retain possession, although the indemnity and proprietary interest endure in the assets in the hands of the new trustee until satisfied.[24]

41. Some of the risks sought to be addressed by this recommendation may be reduced by some of the other recommendations (e.g. making *ipso facto* clauses ineffective). But some risks will remain, including where (as sometimes occurs) a company is replaced as trustee just before the commencement of insolvency proceedings. It is preferable that the position is made clear and that the former trustee have a right to retain possession as against a new trustee. Again, this will assist in achieving a just outcome for creditors and making it harder to phoenix businesses and assets.

Recommendation (5): Distribution of proceeds of right of indemnity

42. As noted above, the Committee recommends that a set of default rules apply to the distribution of proceeds of enforcement of the right of indemnity, with a broad s 447A-esque power available to vary their application as the justice of a particular case requires.

43. With two exceptions, the default rules should respect existing trust law principles and, for the most part, follow what is already done by external administrators of corporate trustees and former trustees that are left holding "trust" assets, which is to use trust assets only to pay trust liabilities.[25]

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23 This is similar to a submission previously advanced by the Committee in 2017 – see our letter to Attorney-General Brandis of 16 June 2017 at [66].

24 In practice it is rare for the Courts to make orders for possession in favour of a new trustee without steps also being taken, often by way of appropriate orders or undertakings, to protect the former trustee's right of indemnity and the beneficial proprietary interest it generates : see for example *Hillig v Darkinjung Local Aboriginal Land Council* [2006] NSWSC 1371 at [17]-[18] where the Court required a sum to be paid into Court sufficient to cover the former trustee's indemnity; *Kemtron Industries Pty Ltd v Commissioner of Stamp Duties (Qld)* [1984] 1 Qd R 576, 587 where the Court permitted the former trustee to retain sufficient trust assets to cover its claim for indemnity; *Pitard Consortium Pty Ltd atf the Pitard Trust v Les Denny Pty Ltd* [2019] VSC 614 at [39] where vesting orders were made in favour of new trustees with the benefit of undertakings to the Court to ensure that, until further order, they would preserve the value of the trust property.

25 The principles from *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99 on this issue were confirmed in 2018 in *Jones (Liquidator) v Matrix Partners Pty Ltd, in the matter of Killarnee Civil & Concrete Contractors Pty Ltd (in liq)* [2018] FCAFC 40; 260 FCR 310 by two members of the Full Federal Court (Allsop CJ at [105]-[108] and Farrell J at [201]), and in 2019 in *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth* [2019] HCA 20; 368 ALR 390 per Gordon J at [169]-[171].

44. The first exception is discussed under "*(1) Scenario 1: The "simple case*" below, which applies where the company is trustee of one trading trust and, other than inadvertently, did not trade or act in its own capacity.

45. Although, as a matter of existing trust law, trust assets may only be used to pay trust creditors, in the Committee's view, in some cases this can produce an unjust result in liquidation, particularly in insolvency. It also notes that, in many insolvency cases, particularly in the "simple case", the beneficial interest that the trustee's indemnity generates in assets entirely displaces the interest the beneficiaries had held.

46. Where the trustee's indemnity involves a right of exoneration, the law requires those proceeds to be paid only to "trust creditors", that is, creditors of the trustee whose debts were properly incurred with authority in the course of trust business.[26] The Committee recommends that, in "simple" trust cases (such as those set out in "Scenario 1" below), this should be altered.

47. At least in "simple cases", the ordinary trust law principle ought not to apply in insolvency. That is because the ordinary principles discriminate against "non-trust creditors", who may have been unaware that the company was a trustee, that (for transactions with non-trust creditors) it was acting in its own capacity (even if inadvertently), and that what appeared to be its own assets were in fact trust assets.

48. This change for "simple cases" would be consistent with the general approach of insolvency, which – as a general rule – is a collective process that seeks to treat creditors equally and where ordinary transactions, which would be valid but for insolvency, are "void as against the liquidator".

49. In "simple cases", treating trust and non-trust creditors as equally entitled to the proceeds of the enforcement of the indemnity would achieve fairness amongst the creditors who dealt with the company, eliminating a "snakes and ladders" outcome where some creditors recover, and some do not. This best achieves the core principle of insolvency law of an equitable *pari passu* distribution of what assets remain from a failed business. Importantly, in micro-economic terms, it will also mean a rateable distribution of the losses of a failed business. This spreads the impact of the losses across creditors, rather than concentrating the impact on just the unlucky (non-trust) ones.

50. The second exception is that, to the extent the company's own assets are insufficient to pay the costs and expenses attributable to the administration of the company's own non-trust affairs, they are to be paid from trust assets in the statutory order of priority.

(1) Scenario 1: The "simple case"

In the "simple case", where the company is trustee of one trading trust and, other than inadvertently, did not trade or act in its own capacity -

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[26] *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth* [2019] HCA 20; 368 ALR 390 at [44], [92] and [186]

(a) The distinction between trust and non-trust creditors is not to be relevant in this case. All should be treated the same and paid out of the company's property, being the proceeds of enforcement of the right of indemnity.

(b) Distributions are to be made in accordance with the statutory scheme of priorities.

(c) If the value of the right of indemnity (i.e. the total of trust debts and expected total costs and expenses of the winding up) is **less** than the total value of trust assets and their sale produces a surplus of funds, the surplus (in which the company has no proprietary interest) must be set aside, to be remitted to a new trustee or at the beneficiaries' direction at the end of the liquidation, subject to Court order.[27]

(2) Scenario 2: Multiple trusts, or where the trustee traded more than one capacity

Where the company is trustee of multiple trusts, or traded both in its trustee capacity and in its own capacity[28] -

(a) Company property and trust property are to be kept and administered separately to the extent possible, with each directed to the relevant (different) group of creditors.

(b) Distributions are to be made from each fund to that fund's creditors in accordance with the statutory scheme of priorities.

(c) The costs of the winding up are to be apportioned between the trusts and the trustee's own capacity as follows[29] –

(i) Costs and expenses attributable to the administration of each trust are to be borne by it.

(ii) Costs and expenses attributable to the trusts as a group, or where it is not possible to determine to which trust in particular the cost or expense relates, are to be apportioned pro rata across the trusts.

(iii) Costs and expenses attributable to the administration of the company's own non-trust affairs, or which are not clearly attributable to the trusts, are to be borne by the company itself. But, to the extent the company's own assets are insufficient to pay these costs and expenses, they are to be apportioned pro rata across the trusts.

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27 It is acknowledged that the total costs of the winding up may exceed what was initially anticipated. For this reason, subject to Court order, the liquidator may hold this portion of the proceeds until the winding up is complete and the full extent of the right of indemnity is known. Thus, if the value of the right of indemnity proves to be greater than initially thought, this portion awaiting remittance to a new trustee or at the beneficiaries' direction may be reduced accordingly.

28 This is essentially a codification of the position that obtains in equity pursuant to *In re Suco Gold* on this issue, and *Carter Holt* (esp per Gordon J).

29 This is framed also bearing in mind the outcomes in cases including: *Staatz v Berry, re Wollumbin Horizons Pty Ltd (in liq)(No 3)* [2019] FCA 924 and *LM Investment Management Ltd v Whyte* [2019] QSC 245.

(3) A general power: The Court is to have a general power along the lines of s 447A to vary or otherwise make such order as it considers appropriate about how these default provisions are to operate in relation to a particular company.

(a) There should also be a legislative provision stating the objects of the treatment of trusts under the Corporations Act, which would then inform the use and application of the s 447A-esque power.

(b) This should ameliorate those cases where the application of the default provisions to the typical cases may be difficult, impracticable, or result in injustice. Something along these lines was suggested in the Harmer Report.[30]

Recommendation (6): Preference recoveries

51. In the simple cases described in "Scenario 1" above, the treatment of preference recoveries will give rise to no uncertainty. The proceeds of such recoveries are distributable amongst all creditors.

52. In the more complex case described in "Scenario 2" above[31]:

(a) the proceeds from preference recoveries relating to payments of trust money are to be returned to that fund/trust to which the debt related and from which it appears the payment/s came;

(b) the proceeds of preference recoveries relating to payments of non-trust money are to be returned to the company's general (non-trust) estate;

(c) if it is unclear as to whether the debt the subject of the preferences was a trust debt or a non-trust debt, or to which trust the debt related, or whether the money used to pay the debt was trust money (and from which trust), the liquidator must apportion the proceeds of the preference recovery pro rata across the trusts and the company's general estate;

(d) the liquidator should seek directions if clarity or judicial guidance would be useful in the interests of justice in a particular case.

Recommendation (7): Other reforms to protect beneficiaries / unitholders

53. The Committee makes two recommendations.

54. First, the rule in *Hardoon v Belilios* is not to apply to trusts. A national approach on this should be taken, adopting the provisions of s 100A of the *Trustee Act 1925* (NSW), for the reasons articulated by the NSW Law Reform Commission.[32]

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30 At [265], last paragraph.

31 Applying and extending the principles from *Commissioner of Taxation v Lane* [2020] FCAFC 184

32 For the reasons articulated compellingly in Report 144, *Laws relating to beneficiaries of trusts*, NSW Law Reform Commission, May 2018; see also Campbell, JC, *The Undesirability of the Rule in Hardoon v Belilios*, [2020] USydLRS 22; 92020) 34:3 Trust Law International 131.

55. Second, the Corporations Act should be amended to clarify that the oppression provisions apply to trading trusts. The Victorian Law Reform Commission explained the need for such a reform in its report, *Trading Trusts – Oppression Remedies,* published in January 2015.[33]

Recommendation (8): Statutory indoor management rule

56. For the same reasons that the statutory indoor management rule applies to companies,[34] the Committee recommends that a similar set of statutory assumptions apply to third parties dealing with a corporate trustee. Creditors should be entitled to assume that a trustee with whom a creditor is dealing is properly performing its duties as trustee. In this way, creditors would not be unjustly prejudiced by the trustee's right of indemnity – upon which the creditor's right to be paid from trust assets hinges – being compromised or reduced by a breach of trust by the trustee.

57. There could be a legislative provision enabling trust beneficiaries or other affected parties to challenge the operation of the provisions applying the statutory indoor management rule to trusts, if the justice of the case calls for an exception in a particular case.

Recommendation (9): Trusts not to be treated as separate economic entities

58. The Committee has considered the merits of treating trusts in insolvency as if they were separate entities. As mentioned above, the Committee does not support that approach.

59. The Committee is aware that such treatment has been suggested as a possible option by other stakeholders. A similar model has been proposed in relation to sub-funds of corporate collective investment vehicles (**CCIVs**).

60. There are several features of the proposals in relation to CCIVs which support treating sub-funds as separate economic entities in insolvency. Those include:

    (a) A CCIV only acts as the operator of sub-funds and cannot act in its own capacity. All liabilities incurred and assets owned must be attributable to sub-funds.

    (b) Only sub-funds can be the subject of insolvency appointments. A CCIV cannot be wound up. Statutory demands can only be served on sub-funds. Receivership applies to each sub-fund, as does winding up and schemes of arrangement.

    (c) A sub-fund cannot be put into voluntary administration or be the subject of a small business restructuring. Voluntary administration does not apply because a CCIV does not carry on an active business, rather the sub-funds do. Small business restructuring does apply.

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33 Available at <https://www.lawreform.vic.gov.au/publication/trading-trusts-oppression-remedies-report-pdf/>. But see the differing views of the New South Wales Law Reform Commission in its report, *Review of laws relating to beneficiaries of trusts* (May 2018) <https://www.lawreform.justice.nsw.gov.au/Pages/lrc/lrc_current_projects/Beneficiaries/Beneficiaries.aspx>

34 See ss 128 and 129 of the Corporations Act.

(d) Notwithstanding that the insolvency provisions apply on a sub-fund-by-sub-fund basis, the CCIV is the relevant legal entity. Sub-funds are not deemed to have separate legal personality in insolvency (or at all). This is said to be because it "ensures that the legal character of a sub-fund remains consistent throughout its life and a sub-fund does not become imbued with legal personality when it enters into external administration."

61. The CCIV regime is reliant upon the CCIV never being insolvent. In relation to trading trusts, that could not be achieved for trustees unless:

(a) they were prohibited from acting in their own capacity; and

(b) their liability for trust liabilities was always limited to the available trust assets.

62. Otherwise, any separate economic entity model for trusts would have to accommodate the insolvency of the trustee as well, which creates an additional layer of complexity. For example, how would the trustee's personal liability for trust debts that could not be satisfied from the trust's assets be dealt with? Would the insolvency administrator administering the trust have the right to seek payment from the trustee in its own capacity and be able to rely on that liability to seek to wind up the trustee and claim in its insolvency?

63. It would not be appropriate, in the Committee's view, for voluntary administration and small business restructuring not to be available to trusts. It is difficult to see how either of these regimes could operate on a trust-by-trust level. For example, where only one trust became insolvent (assuming there was a statutory definition to determine such insolvency), it is difficult to see how only that trust could be the subject of voluntary administration or restructuring, while the trustee is separated out continues to operate normally in respect of its own affairs and as trustee of other trusts.

64. There will also be difficulties in applying receiverships separately to each trust. If the appointment of a receiver over the assets of a trust requires the receiver to treat it as a separate economic entity, the provisions relating to receivership will have to apply separately to that trust, such as s 433. That may mean that employees miss out on priority where they otherwise would not if all the trustee's assets floating charge assets were available.

65. We also see difficulties in that whether a trust could be deemed to be solvent or insolvent is often inextricably linked with the liabilities and assets of its trustee, due to trust law principles, and inextricably linked with the scope of the right of indemnity of the trustee. This right, as High Court authority has finally confirmed[35] (though not with unanimity) generates a prior beneficial interest in the "trust" assets. The scope of the right of indemnity from "trust" assets, in many cases including the so-called "simple" cases, includes either all of, or a *pro rata* proportion (in the case of multiple trusts) of, the costs of the external administration. As such it is not necessarily of a fixed amount at an early point. To seek legislatively to extricate out an assessment of whether a

[35] *Carter Holt Harvey Woodproducts Australia Pty Ltd v Commonwealth* [2019] HCA 20; 368 ALR 390

"trust" is insolvent and at what point that could be assessed, could be problematic. If an external administration produces a surplus of trust assets to be paid over to a new trustee or otherwise at the beneficiaries' direction, that can be and is already done.

66. Moreover, to treat a trust as if it were a separate entity in insolvency, and to allow for the appointment of a separate, additional external administrator to the trust from the external administrator of the trustee company could unnecessarily increase the costs burden imposed on the remaining assets.

67. In the majority of the simple cases, there is but one trustee company which does nothing but trade acting in its capacity as trustee for the one trust. In our experience in the majority of cases, where the trustee is insolvent, so too effectively is the trust - creditors are not paid out in full and there is no surplus to go to beneficiaries or a new trustee.

68. In the less common cases, indeed in any case, if it is desirable that a separate external administrator be appointed to the trust assets, there already exists the power for this to be done by appointment of a receiver. Notably, in practice in the majority of cases, the person who is appointed as receiver is the person who is already the liquidator of the trustee company.

69. The Committee does not say these are the only possible issues associated with treating trusts as separate economic entities in insolvency, but they are some that the Committee has identified in preparing this submission.