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Insolvent Simple Trading Trusts – a 'simpler' solution

Submission to the Manager, Market Conduct Division, Treasury
Clarifying the treatment of trusts under insolvency law

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The Federal Government has announced its aspiration to build on the insolvency reforms which it commenced as a response to the economic consequences of the COVID-19 pandemic. It has identified a specific area of interest in the intersection of trading trusts and insolvency law, suggesting a small business context for these reforms. This submission is offered in response.

'Big Bang' or 'Light Touch'?

The issue of trusts and insolvency has been the subject of proposals for reform going back at least to 1988 when the Australian Law Reform Commission had canvassed the issues as they were then in the Harmer Report[1], and had proposed a comprehensive package of reforms. This submission will be limited to a consideration of one of those proposals, being the limit on powers to remove a trustee.[2]

In the absence of legislative regulation[3], there has been a historical pattern of judicial development and clarification albeit with inconsistencies across Australian jurisdictions[4]. At this juncture, we are now faced with two options for reform – a 'big bang' comprehensive statutory regulation of trading trusts or to provide a 'light touch' reform to the most immediate concerns arising from small business trading trust insolvencies.

The trading trust – a paradox

The popularity of trading trust arrangements derives from their *"….ease of establishment, unincorporated status, lighter regulatory framework and more tax-effective distribution of business income under a trust structure…"*[5] By providing adaptability and flexibility, trusts satisfy the economic and social needs of a significant proportion of Australian business. Yet trading trusts by their nature are a paradox - by not having status as a legal entity, a trust itself cannot become bankrupt or insolvent. However, much of Australian enterprise, especially small and family run businesses across a variety of sectors, operate using insolvency-resistant trading trusts which are managed by insolvency-susceptible incorporated trustees as distinct from the trusts they administer. The cumulative impact of trading trust insolvency is significant as much as it is complicated by this paradox.

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[1] Law Reform Commission, General Insolvency Inquiry Report No 45 (1988) Volume 1 at [239]–[271] (**Harmer Report**).
[2] Harmer Report at [254]-[258].
[3] Chief Justice Bathurst, 'Commercial Trusts and The Liability of Beneficiaries: Are Commercial Trusts a Satisfactory Vehicle To Be Used in Modern Day Commerce?' (Harold Ford Memorial Lecture, 5 October 2021) at [22] (**Bathurst**).
[4] For example, there has been a divergence of approaches to a number of issues including the application of trust proceeds and associated priorities of those proceeds. Divergent approaches were illustrated by the judgments in *Re Enhill Pty Ltd* [1983] 1 VR 561 and *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99 which was resolved where there were only trust creditors by the High Court in *Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth* [2019] HCA 20, with the Court finding inter alia that trust proceeds may only be applied to trust creditors and that the statutory priorities in ss 433 and 556 of the *Corporations Act 2001* apply. There was also divergence in the consideration of the existence of a liquidator's power of sale of trust property without prior court approval. This was illustrated in *Apostolou v VA Corporation Aust Pty Ltd* [2010] FCA 64 and *Kitay, South West Kitchens (WA) Pty Ltd* [2014] FCA 670 on the one hand and on the other, authorities such as *Caterpillar Financial Australia Ltd v Ovens Nominees Pty Ltd* [2011] FCA 677. This was resolved by the Full Federal Court in *Jones v Matrix Partners Pty Ltd; Re Killarnee Civil & Concrete Contractors Pty Ltd (In liq)* [2018] FCAFC 40 (**Re Killarnee**) finding that a power of sale necessarily requires an order of the court.
[5] Bathurst at [20] citing N D'Angelo, *Transacting with Trusts* (LexisNexis Butterworths, 2014), p79.

A short case for 'Light Touch'

It might be suggested that the widespread use of corporate trust structures may in fact be a direct result of the paucity of legislative intervention over the last four decades.[6] That said, trust-related insolvency issues have been readily dealt with by courts of equity. As Chief Justice Allsop has stated, *"…the application of equitable principles in the context of insolvency and corporations statutes is a matter of core competence of the courts*"[7] (my emphasis).

Any reform should be cognisant of the scale of trading trust usage in Australia as well as the general evolutionary approach to the law[8] to ensure that reform, as Chief Justice Bathurst has cautioned:

> *"… should not take away the simplicity of the trust. Commercial trusts were historically favoured due to their ability to circumvent the difficulties of incorporation, and currently so, to circumvent the regulatory regime of the Corporations Act. I think it is important that any reform does not create an onerous and inflexible regulatory framework that erodes flexibility, whilst ensuring both creditors and beneficiaries are adequately protected."* [9]

Whilst many stakeholders and advisers, for diverse reasons, may seek a more comprehensive regulatory regime, the risk of unintended consequences for a system that many contend is in fact working to the benefit of most stakeholders in the small business sector should be avoided. As such, what is suggested is an option for change which does not unduly disturb the current legal framework.

A problem: trustee 'auto-ejection' clauses

The model of Australian insolvency law is predominantly based on private appointments with court oversight. That being said, trust deeds with their almost universal provision of trustee vacation and replacement, create a default situation where active court involvement is needed from the outset of an insolvency appointment. These 'auto-ejection' clauses, as they are commonly known, serve to automatically remove an entity from its role as a trustee immediately upon that entity entering an insolvency process. Prior to the appointment of a new trustee (if any), the former trustee's functions are reduced to those of a bare trustee which holds legal title to trust assets with only the rights and obligations to preserve those assets.[10]

Auto-ejection clauses are usually included for the protection of the trust and its beneficiaries against a clearly unsuitable trustee.[11] In circumstances where it is clear that the trading trust, were it to have the status of a legal entity, would be insolvent, then this type of clause has a perverse consequence. These clauses, which carry the right to appoint a new trustee, whilst being for the ultimate benefit of beneficiaries, are contrary to a major public policy aim of Australian insolvency law, being the maximisation of return to creditors.

Where the administrator or liquidator (an insolvency practitioner (**IP**)) appointed to a corporate trustee has been reduced to a bare trustee as a consequence of an auto-ejection clause, they will be required to approach the court to be granted a power of sale or appointed as receiver to avoid personal liability for breach of trust.[12] A typical sequence of events would see an IP applying to the court to be appointed as receiver and manager over the trust property. As a court-appointed receiver, the IP would be required to make further applications to the court to seek orders as to the disposal of trust assets, remuneration, distribution of trust proceeds and discharge from the appointment. This process will typically require at least two separate applications to be made. The cost is frequently in the tens of thousands of dollars, if not more.

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[6] Bathurst at [70].
[7] Chief Justice Allsop, 'The Intersection of Companies and Trusts' (Harold Ford Memorial Lecture, 26 September 2019).
[8] Bathurst at [66].
[9] Bathurst at [81].
[10] See *Bruton Holdings Pty Limited (In Liq) v Commissioner of Taxation* [2011] FCAFC 79 at [15]-[16] & [21].
[11] N D'Angelo, *Transacting with Trusts and Trustees* (LexisNexis, 2020) at [9.34].
[12] See discussion in *Cremin, in the matter of Brimson Pty Ltd* (in liq) [2019] FCA 1023 at [48]-[50].

In the absence of an auto-ejection provision, the IP would arguably retain the powers laid out in the trust deed.[13] This would typically entail the powers to operate the trust business, dispose of trust assets and make distributions, and unless specifically excluded by the trust deed, the IP would continue the insolvency process as a routine corporate insolvency.

Hence, this mandated court supervision currently imposes a greater economic burden on trust creditors than otherwise would be required in a routine corporate insolvency process. It is contended that the administrative efficiency and asset value retention aspirations of Australian insolvency law are automatically undermined by the operation of an auto-ejection clause.[14] This would be particularly felt in small business insolvencies where the available asset pool is small relative to the costs of mandated court processes. In view of this, there would be benefit for the legislation to reform time-consuming and costly court processes in a small business context.

'Simple Trading Trusts' – the ipso facto prohibition solution

It is contended that there is a species of corporate trustee / trust arrangement which, with respect to its insolvency, can be codified with sufficient precision so as to achieve maximum benefit to stakeholders without disturbing the current utility of business trust arrangements. Such a trading trust has assets only utilised for trading purposes, whose sole function is as trustee of that trust and no other trust and where such a trustee does not undertake any trade in its own right. This arrangement has been judicially described as a "plain vanilla situation".[15] These arrangements may be termed the *'Simple Trading Trust'* arrangement. This is in fact a common arrangement seen in small business partnerships and family enterprises.

As will be developed below, a specific legislative override of auto-ejection clauses in the context of a Simple Trading Trust could be achieved with significant benefit to all parties including IPs, trust creditors and the Commonwealth (through its obligations under the *Fair Entitlements Guarantee Act 2012*) utilising an existing statutory mechanism. That simple mechanism is the prohibition on enforcing so-called 'ipso facto' clauses, discussed in more detail below. First it is worth specifying the characteristics of the Simple Trading Trust which would benefit from the application of this simple mechanism.

Features of a Simple Trading Trust

There has emerged a reasonably consistent body of case law with respect to insolvencies involving such Simple Trading Trusts (although not without inherent uncertainties depending upon the Australian jurisdiction). As mentioned earlier, this sees courts grant either a power of sale to the liquidator to validate a past disposal of trust assets or the appointment of the liquidator as receiver and manager for any proposed disposal. This occurs in particular where:

1. the presence of an auto-ejection clause has left the corporate trustee as a bare trustee with legal title and no other rights or powers other than to preserve trust assets;

2. a new trustee has not been appointed in its place;

3. the corporate trustee has no creditors in its own right; and

4. only one trust is in operation.[16]

[13] Re Killarnee at [90].
[14] Harmer Report at [254], [257].
[15] *Rathner, in the matter of Garrows Close Pty Ltd (in liq)* [2021] FCA 505 at [30], also see L Aitken and H Durack, 2021, 'Ask The Expert: Does the liquidator of an insolvent trading corporate trustee invariably need to appoint a receiver?' *Australian Banking & Finance Law Bulletin* (July 2021) pp47-49 at 48, who identified a vanilla type of arrangement as a possible opportunity for reform.
[16] See for example *Deppeler, in the matter of Asten Holdings Pty Ltd (in liq)* [2020] FCA 1107; *Brereton, in the matter of MyHouse (Aust) Pty Ltd (admins apptd)* [2020] FCA 610; *Hughes, in the matter of Substar Holdings Pty Ltd (in liq)* [2020] FCA 1863, *Re Total Truss Systems Pty Ltd* (in liq) [2021] VSC 205, *Naidenov, in the matter of The Sweet Life Farms Australia Pty Ltd (in liq)* [2020] FCA 1474; *Re Pako Supermarkets Pty Ltd (in liq)* [2020] VSC 487; *Byrnes, in the matter of St George's Development Company Pty Ltd (in liq)* [2018] VSC 595; *Re Matthew Forbes Pty Ltd (in liq)* [2018] VSC 331.

Given that in this particular scenario, courts have effectively overridden the express intentions of trust appointors by consistently appointing the IP as receiver or granting a power of sale, it is arguable that this customary, practical but presently expensive fix should be codified, obviating the need for these court applications in Simple Trading Trust scenarios.

An existing mechanism for reform

The stay on enforcement of contractual laws provisions enacted into the *Corporations Act 2001*[17] known as the 'ipso facto' regime, provides an existing mechanism by which the proposed override of trustee auto-ejection clauses can be effected efficiently.

In summary, the ipso facto regime provides a bar to enforcement of rights in contracts, agreements or arrangements entered post 1 July 2018, that seek to terminate or otherwise enforce arrangements triggered by certain insolvency processes of the entity unless an exemption applies. The legislation was designed to preserve value in the insolvent entity by giving opportunity or 'breathing space' to facilitate restructuring to the extent possible or to dispose of the business as a going concern, ultimately for the benefit of creditors.[18]

Whilst an auto-ejection clause would be captured by this statutory bar, it is arguable that the exemptions set out in the *Corporations Regulations 2001*[19] and the *Corporations (Stay on Enforcing Certain Rights) Declaration 2018* (**Declaration**) might negate the operation of the bar.[20] Specifically, the exclusion in sub-clause 5(4)(j) of the Declaration, being a right to perform obligations or enforce rights or engage another to do so, might exclude an auto-ejection clause from the bar to enforcement. There is currently sufficient doubt as to whether an auto-ejection clause can be stayed in a voluntary administration, a liquidation (where it follows a voluntary administration, scheme of arrangement or a small business restructuring), a scheme of arrangement, a receivership (where the appointment is to the whole or substantially the whole of the company's property), or in a small business restructuring. The operation of the ipso facto provisions with respect to auto-ejection clauses has to the best of the writer's knowledge not been judicially considered. In view of this uncertainty and their personal liability, IPs might be naturally reluctant to invoke the ipso facto provisions.

What is proposed is a provision within the current ipso facto framework that explicitly provides for a stay on auto-ejection clauses in trust deeds of defined Simple Trading Trusts. At a minimum, this would apply to trust arrangements entered post 1 July 2018 and to the insolvency processes listed above, consistent with the current operation.

This would put beyond doubt the IP's rights to continue to deal with trust assets in line with the trust deed without the need for prior court approval. It is contended that this proposal is a simple refinement of the current ipso facto regime which would be consistent with the stated objectives of those reforms. Were the Commonwealth minded to extend the operation of the bar to enhance the reform, it might consider extending the bar to trust deeds entered prior to 1 July 2018 and to all insolvency processes, specifically to include a winding up initiated by court appointment or a creditors' voluntary winding up.

The Simple Trading Trust proposal summarised

In summary, the Simple Trading Trust proposal:

1. provides a statutory definition of a 'Simple Trading Trust';

2. provides a mechanism for the retention of the company as trustee of the Simple Trading Trust via a bar to the enforcement of auto-ejection clauses within the existing ipso facto regime; and

[17] *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* (Cth).
[18] Explanatory Statement, Corporations (Stay on Enforcing Certain Rights) Declaration 2018.
[19] See regulations 5.1.50, 5.2.50, 5.3A.50, 5.3B.12 of *Corporations Regulations 2001*.
[20] D'Angelo at [9.68]-[9.70].

3. in the alternative, considers extending this bar to enforcement, to trust deeds entered prior to 1 July 2018 and to all insolvency processes.

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It is contended that this proposal simplifies the insolvency processes for Simple Trading Trust arrangements to the benefit of all stakeholders, representing a solution to a frequently encountered problem faced by small business and IPs. The proposal can operate without undue disturbance to the more complex functions of trading trusts which are a common and arguably efficient mechanism for business in Australia.