Mark Wellard

Academic
c/- P.O. Box 123
Broadway NSW 2007

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The Manager
Market Conduct Division
The Treasury
Langton Crescent
Parkes ACT 2600
By email: MCDInsolvency@Treasury.gov.au

Dear Sir/Madam

Submission on 'Clarifying the treatment of trusts under insolvency law'

Thank you for the opportunity to provide a submission on the treatment of trusts under Australian insolvency law. This submission is my own (as an independent academic) and should not be attributed to UTS or UTS Law.

Credentials

I am a Senior Lecturer in Law at UTS Law (Sydney). I am a published insolvency law academic and have been a lecturer in insolvency law for eight years. Prior to academia and two years as ARITA's Legal Director, I spent 10 years as a solicitor in private practice with firms in Australia and the United Kingdom (qualified in both jurisdictions) specialising in insolvency law and commercial litigation.

In my current role at UTS Law, I am the Program Head and principal lecturer of the 'ARITA Advanced Certification (Insolvency)', a postgraduate-level course of study which fulfils the requirements laid down by the *Insolvency Practice Rules (Corporations) 2016* (Cth) ('IPR') s 20-1(2)(b) (academic requirements of applicants for registration as a liquidator).

Priority matters for reform and legislative intervention

The comprehensive submissions of ARITA and Law Council of Australia (Insolvency & Restructuring Committee, Business Law Section) highlight the 'first order' (priority) issue of clarifying the powers of external administrators (especially liquidators under s 477 of the *Corporations Act 2001* (Cth) ('the Act')) to deal with and sell trust property (legally owned by an insolvent corporate trustee and subject to the insolvent trustee's right of indemnity) without the necessity of an application to court to be appointed as receiver of such property.

I support the notions of:

- Prohibiting the operation of clauses in trust deeds which provide or allow for:
    - The automatic ejection of a corporate trustee upon external administration; and/or
    - The removal and replacement of a corporate trustee upon external administration without external administrator consent or court approval;

- Legislating that any reference in Chapter 5 of the Act to the business or affairs of a company shall be taken to include a reference to the company's business or affairs as trustee;

- Extending the definition of 'property of the company' in Chapter 5 of the Act to cover the property of a trust to the extent that the insolvent corporate trustee is entitled to an indemnity out of (and a proprietary interest in) the trust property. For provisions such as ss 437D or 468 of the Act this definition could be even broader (explained further below);

- Establishing a public, searchable register of trading trusts to provide more transparency for creditors transacting with a corporate trustee. Where a company incurs debts in two different capacities – say, as trustee and also in its own capacity – this will go some way towards remedying the unsatisfactory (if not unjust) outcome that 'non-trust' creditors are not entitled to participate in any distribution from proceeds of the insolvent trustee's right of exoneration that is limited to debts incurred to 'trust' creditors. 'Non-trust' creditors may well be unaware they are extending credit to a company whose assets are held on trust and that, in the event of insolvency, the company's 'trust' creditors stand in a 'favoured position' in terms of the distribution of those trust assets.

  This 'favoured position' of 'trust' creditors over 'non-trust' creditors was well explained by Derrington J in *Lane (Trustee), in the matter of Lee (Bankrupt) v Deputy Commissioner of Taxation*:[1] (emphasis added)

> *When the limited nature of the right of exoneration is fully appreciated, full respect is accorded to the established "favoured" position of trust creditors on a trustee's insolvency. In the course of submissions* ***the Bankruptcy Trustees submitted that the trust creditors obtained this benefit by "mere happenstance" or it being a "lucky incidence" of doing business with a person who happened to be a trustee****. They relied upon that as a substantiation for the conclusion that the right of exoneration should be available to all creditors. There are a number of answers to this proposition. First,* ***if, as a matter of law, it is the case that the special rights of trust creditors to be subrogated to the trustee's right of indemnity afford them an advantage in the insolvency context, there is no reason to deny them that right on some perceived notion of general "fairness"****. Second, it is not apparent that those who traded with Mr Lee's Subway franchise were not aware that he was conducting business as a trustee. The trading trust has become a ubiquitous part of modern commerce such that it may well be that the trust creditors, or some of them, knew of their rights and entitlements. Even though the franchisor was not a creditor*

[1] *Lane (Trustee), in the matter of Lee (Bankrupt) v Deputy Commissioner of Taxation* [2017] FCA 953 at [100] per Derrington J.

> *in the administration of Mr Lee's estate, given the size of its business around Australia, it is most likely that it was acutely aware of the nature of its rights arising from trading with its franchisee, Mr Lee, who operated his business as a trustee. Third, the "favoured position" of trust creditors is now so well established that it is not appropriate for a Court at first instance to ignore it.* ***If any reform is required in this area it is clearly a matter for the legislature****. Fourth, it is simply not possible to use a power to pay trust creditors out of trust funds, to meet the claim of non-trust creditors.*

Indeed, in conjunction with or as an alternative to establishing to a register of trading trusts, I submit that serious consideration be given to a legislative override of this 'favoured position' of 'trust' creditors such that, in the event of a liquidation of a corporate trustee, 'trust' and 'non-trust' creditors are equally entitled to receive a distribution out of trust assets through and to the extent of any right of exoneration enjoyed by the corporate trustee.

To the extent that such legislation would offend or violate trusts and equity doctrine, I make the observation that there is nothing new in the notion of insolvency legislation interfering with or overriding established legal or proprietary rights to deliver, as a policy objective, equitable outcomes to all creditors of a company. For example, a secured party's collateral under a perfectly valid but unregistered security interest in personal property may vest in the company upon a liquidation. Another example is that of unsecured creditors who have lawfully received payment of their debt yet may be required to disgorge those moneys to a liquidator if the payment is characterised as an unfair preference. The 'favoured position' of 'trust' creditors *upon a company's liquidation*, whilst correct as a matter of legal doctrine, is difficult to defend or justify as a matter of policy and the treatment of stakeholders in a company's insolvency.

Perspectives on the effect of liquidation and bankruptcy on 'alleged' trust property or where there is uncertainty as to the existence of a trustee's right of indemnity out of trust property

I also provide my own perspective on a matter which is an extension of the issues pertaining to the powers of external administrators to deal with trust property: namely, the *immediate* effect of a liquidation and bankruptcy upon property legally owned by a company over which there may be a dispute as to the very existence of a trust and/or the existence and extent of a trustee's right of indemnity.

I submit that the legislative provisions which prevent unauthorised dispositions of property of a company upon liquidation or bankruptcy (eg, s 468 of the Act in a court-ordered winding up) be amended to ensure that, *whether or not* an asset is held on trust or subject to a trustee's right of indemnity, *once a liquidation or bankruptcy has commenced then any dealing or disposition of that property is void* unless done by or under the authority of the liquidator/bankruptcy trustee or a court order. This legislative amendment would require an even broader definition of 'property' for the purposes of these specific provisions (ie, any property legally owned by a company whether or not held on trust and whether or not subject to a right of indemnity enjoyed by the company as trustee).

This amendment would not adversely affect, prejudice or abrogate the interests of the ultimate (proven) true beneficial owner of trust property held by a company, but would ensure that *all* property

legally owned by a company is 'locked down' immediately upon appointment of a liquidator or bankruptcy trustee. This will avoid the need for insolvency practitioners to obtain costly injunctive relief merely to preserve the status quo, secure property legally owned by a company in liquidation or a bankrupt and prevent dealings by parties who may assert a beneficial interest in such property.

Similar amendment could be made to the *Bankruptcy Act 1966* (Cth) ('BA') to ensure that 'mere' legal title vests in a trustee-in-bankruptcy under s 58 of the BA. How and to whom 'contested' property is to be distributed will be determined according to who is found to hold the beneficial interest in the bankrupt's property. Appropriate legislative amendment would effectively address the practical problems with the present law that can be observed from the High Court's decision in *Boensch v Pascoe* [2019] HCA 49: presently, bankruptcy trustees may need to take action (eg, lodge a caveat over real property or obtain injunctive relief from a court in respect of personal property) to 'lock down' or secure an asset that is legally owned by the bankrupt but over which there exists a dispute or uncertainty as to a trust arrangement or, if there is a trust, whether or not a trustee's right of indemnity applies to such property to sustain a proprietary interest on the part of the bankrupt trustee.

Similar consideration of these issues may be applied to s 437D in Part 5.3A (Voluntary Administration) which serves a similar purpose to s 468 in liquidation but in a very different context.

These issues and the case for reform are explained in detail in my *Insolvency Law Journal* article 'The Effect of Bankruptcy and Liquidation on Trust Property: Recent High Court Judgments and Implications for Insolvency Practitioners and Post-Appointment Dealings and Dispositions' (2020) 28 *Insolv LJ* 29.

Australia needs a 'root and branch' review of its insolvency law regime for a 21st century economy including expert economic perspectives

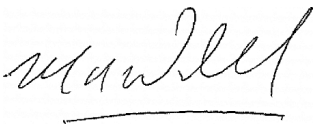
Finally, I commend and renew ARITA's call for a 'root and branch' review of Australia's personal and corporate insolvency laws. Our present corporate and insolvency laws present a complex system of interrelated 'moving parts'. In my view, such a review must incorporate input from economic experts on the role and expectations of our insolvency laws in the context of Australia's economy today (a very different economy to that of 1988 when the Harmer Report[2] was delivered). I commend the Government's goal of 'further simplifying and streamlining insolvency law so that viable businesses that do encounter economic challenges have the opportunity to restructure and go on trading'. However, the impact our insolvency laws must be appreciated in the broader context of contemporary economic conditions, settings and incentives. What national 'economic dividend' can and should we expect from our insolvency regime today?

A considered 'root and branch' review of our insolvency regime will produce better law making and outcomes than the reactive, disjointed law reform measures of the last five years which have, in my view, added a great deal of complexity to our insolvency regime for questionable benefit.

[2] General Insolvency Inquiry (ALRC Report 45), tabled 13 December 1988.

I am more than happy to speak to any of the above points (or my submission generally) and can be contacted by email or via UTS Law.

Yours faithfully,



Mark Wellard
Senior Lecturer, UTS Law